Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1994

THE CITIZENS BANK OF CLOVIS, NEW MEXICO, a corporation,

Petitioner,

vs.

FEDERAL DEPOSIT INSURANCE CORPORATION,

Respondent.

Petition for Writ of Certiorari to the United States Court of Appeals for the District of Columbia Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW

1. IF USING THE STIPULATED, OBJECTIVE, AND VERIFIABLE FACTS HERE LOANS ARE SUBSTANTIALLY SECURED AND THERE IS SOME POSITIVE PERSONAL STATEMENT [PS], i.e., NET WORTH ASSETS, AND OTHER REAL ESTATE OWNED [OREO] BY BANK IS ON BANK'S BOOKS AT APPRAISED VALUE, CAN THE FDIC RATIONALLY CLASSIFY THEM SUBSTANDARD WHEN THE RISK OF LOSS IS REMOTE OR SO MINIMAL AS NOT TO EFFECT THE FINANCIAL INTEGRITY OF THIS WELL-CAPITALIZED BANK?

2. WHERE THE FDIC HAS NOT CONTROVERTED THAT IT HAS TO FOLLOW ITS OWN MANUAL OF EXAMINATION POLICIES [MEP] AND THE INTERAGENCY REGULATORY ENUNCIATIONS OF 3/1/91, 4/26/91, and 11/7/91, ALL OF WHICH LEAD AT THE WORST TO A "SPECIAL MENTION" CLASSIFICATION, IS THE FDIC PRECLUDED FROM CHANGING THE CLASSIFICATIONS TO "SUBSTANDARD" WHERE THE BANK HAS IN GOOD FAITH RELIED ON SUCH MEP AND THE ENUNCIATIONS?

3. SINCE THE FDI ACT IS NOT A "PUBLIC INTEREST" OR "PUBLIC BENEFIT" STATUTE AS ANALOGIZED TO DIMENSION FINANCIAL CORP. V. BOARD OF GOVERNORS OF F.R.S., 744 F.2d 1402, 1408 (10TH CIR.,1984), AFF. 474 U.S. 361, 106 S.CT. 681, 88 L.Ed.2D 691(1986), SAYING THAT THE BANK HOLDING COMPANY ACT [BHCA] IS NOT SUCH, DOES THE FDIC, UNDER THE HERE STIPULATED OBJECTIVE AND VERIFIABLE FACTS, STILL HAVE THE UNLIMITED DEFERENCE OR DISCRETION IN THE CLASSIFICATION OF A BANK'S LOANS AND OREO AS ATTRIBUTABLE TO "PUBLIC BENEFIT" OR "PUBLIC INTEREST" AGENCIES IN SUCH STATUTES AS THE ICC, NRC, FTC, FCC, FPC, OR EPA AS BEING ON THE "FRONTIERS OF SCIENCE" OR "WITHIN A ZONE OF REASONABLENESS?"

4. DOES THE DEFERENCE OR DISCRETION GIVEN BANK REGULATORS IN CHARTERING BANKS UNDER 12 U.S.C. §§21,27 AND BRANCHING UNDER 12 U.S.C. §36, NEITHER OF WHICH REQUIRE A HEARING, APPLY TO THE CLASSIFI-

CATION OF LOANS AND OREO, WHICH DETERMINATIONS ARE SUBJECT TO FULL REVIEW UNDER THE APA AND PARTICULARLY 5 U.S.C.S. §706(2)(E)?"

5. WHEN THE EFFECTIVE DATE WAS EXTENDED ON 12 C.F.R. PART 323 APPLICABLE TO REQUIRING A BANK TO HAVE APPRAISALS BY STATE CERTIFIED OR LICENSED APPRAISERS ON REALTY, DID BANK STILL HAVE TO HAVE AN APPRAISAL BY AN INDEPENDENT APPRAISER WHO IS NOT STATE CERTIFIED OR LICENSED THE ABSENCE OF WHICH WILL SUPPORT A CEASE-AND-DESIST ORDER DESPITE THE FACT THAT SUBSEQUENT CHANGES MADE BANK'S ALLEGED FAILURE NOW LAWFUL?

6. WHEN THE FDIC IN 12 C.F.R. PART 363 REQUIRES OUTSIDE DIRECTORS FOR AN INDEPENDENT AUDIT COMMITTEE ONLY FOR BANKS WITH OVER $500 MILLION IN ASSETS, CAN THE FDIC REQUIRE THIS SMALL BANK TO SIMILARLY HAVE 3 OUTSIDE DIRECTORS UNDER THE FACTS OF THIS CASE WHEN NO MANAGE-

MENT CHANGES ARE REQUIRED, THE EXISTING LOAN AND DISCOUNT COMMITTEE REMAINS THE SAME, AND THE ORDER PREEMPTS NEW MEXICO LAW AS IT ONLY REQUIRES 3 DIRECTORS?

7. CAN THE FDIC SUSTAIN A CEASE-AND-DESIST ORDER FOR FAILURE TO HAVE INSPECTIONS OF COLLATERAL WHEN NO REGULATORY RULE, REGULATION OR POLICY REQUIRES SUCH, AND NO LOSS RESULTED FROM THE LACK THEREOF?

8. CAN THE FDIC SUSTAIN A CEASE-AND-DESIST ORDER REQUIRING BANK TO EXPAND ITS BANK MANUAL WHEN NO RULE, REGULATION, OR POLICY EVEN REQUIRES IT TO HAVE A BANK MANUAL IN THE FIRST INSTANCE AND NO LOSSES RESULTED FROM THE LACK THEREOF?

9. DOES EITHER THE FDIC'S DECISION OR THE ALJ'S DECISION COMPLY WITH THE MANDATORY PROVISIONS OF 5 U.S.C.S. §557(c) REQUIRING A RULING ON EACH FINDING, CONCLUSION, AND EXCEPTION PRESENTED BY PETITIONER AND GIVING THE REASONS OR BASIS

THEREFOR ON ALL MATERIAL ISSUES OF FACT, LAW OR DISCRETIONS PRESENTED ON THE RECORD?

DESIGNATION OF CORPORATE RELATIONSHIPS

This is Petitioner's original Designation of Corporate Relationships.

Petitioner, The Citizens Bank of Clovis, is a New Mexico corporation which is wholly owned by CBC, Inc., also a New Mexico corporation and a one-bank holding company. The three directors of Petitioner are also the three directors and owners of all of the common stock of CBC, Inc. The Citizens Bank of Clovis is the sole subsidiary of CBC, Inc.

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No.....

IN THE SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1994

THE CITIZENS BANK OF CLOVIS, NEW MEXICO, a corporation,

PETITIONER,

V.

FEDERAL DEPOSIT INSURANCE CORPORATION,

RESPONDENT.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

OPINIONS BELOW

THE JUDGMENT OF THE UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT DENYING REVIEW IS NOT REPORTED BUT IS ATTACHED AS P's APPENDIX A [P's A-1a]. THE FDIC'S DECISION AND ORDER ON CEASE-AND-DESIST IS REPORTED IN FDIC ENFORCEMENT ORDERS AND DECISIONS [P-H], FDIC-91-406b,¶5208,p.a2348 AND ATTACHED HERETO AS P's B-3a. THE ALJ'S

RECOMMENDED DECISION IS ATTACHED HERETO AS P's C-20a. THE CITIZENS BANK OF CLOVIS' EXCEPTIONS TO THE A.L.J.'S RECOMMENDED DECISION, FINDINGS, CONCLUSIONS, PROPOSED ORDER, ADMISSION AND EXCLUSION OF EVIDENCE, FAILURE OF THE A.L.J. TO MAKE RULINGS PROPOSED BY RESPONDENT AS REQUIRED BY 12 C.F.R. §308.39 WITH ADDED CITATIONS TO THE RECORD IS ATTACHED AS P's D-71a. Bank's Motion for Stay of Cease-and-Desist Order is P's E-123a. FDIC's Objection to the Motion for Stay of Cease-and-Desist Order is P's F-130a. Decision and Order Denying Motion for Stay Pending Appeal is P's G-143a.

STATEMENT OF JURISDICTION

THE JUDGMENT OF THE UNITED STATES COURT OF APPEALS WAS ENTERED FEBRUARY 22, 1995 AFTER ARGUMENT ON FEBRUARY 14, 1995. THE JURISDICTION OF THIS COURT IS INVOKED UNDER 12 U.S.C. §1818(h) AND 28 U.S.C. §1254.

CONSTITUTIONAL PROVISIONS, STATUTES AND REGULATIONS INVOLVED

DEFINITION OF "SUBSTANDARD LOANS" IN FDIC'S MANUAL OF EXAMINATION POLICIES [MEP], p.3.1-23, ATTACHED AS P's H-145a:

"SUBSTANDARD LOANS ARE INADEQUATELY PROTECTED BY THE CURRENT SOUND WORTH AND PAYING CAPACITY OF THE OBLIGOR OR OF THE COLLATERAL PLEDGED, IF ANY. LOANS SO CLASSIFIED MUST HAVE A WELL DEFINED WEAKNESS OR WEAKNESSES THAT JEOPARDIZE THE LIQUIDATION OF THE DEBT. THEY ARE CHARACTERIZED BY THE DISTINCT POSSIBILITY THAT THE BANK WILL SUSTAIN SOME LOSS IF THE DEFICIENCIES ARE NOT CORRECTED."

DEFINITION OF "SPECIAL MENTION" IN MEP, p.3.1-22, 3.1-23, ATTACHED AS P'S I-155:

"OTHER LOANS OF QUESTIONABLE QUALITY, BUT INVOLVING INSUFFICIENT RISK TO WARRANT CLASSIFICATION, ARE DESIGNATED AS SPECIAL MENTION LOANS....
SPECIAL MENTION - INCLUDED IN THIS CATEGORY ARE LOANS WHICH DO NOT PRESENTLY EXPOSE THE BANK TO A SUFFICIENT DEGREE OF RISK TO WARRANT ADVERSE CLASSIFICATION BUT DO POSSESS CREDIT DEFICIENCIES DESERVING MANAGEMENT'S CLOSE ATTENTION....EXAMINERS SHOULD NOT MISCONSTRUE THE FACT THAT MOST SPECIALLY MENTIONED LOANS CONTAIN MANAGEMENT CORRECTABLE DEFICIENCIES TO MEAN THAT LOANS MERELY INVOLVING TECHNICAL EXCEPTIONS BELONG IN THIS CATEGORY...."

NOVEMBER 7,1991 "INTERAGENCY POLICY STATEMENT ON THE REVIEW AND CLASSIFICATION OF COMMERCIAL REAL ESTATE LOANS", P'S J-157a:

News Release, P's J-157a:
"Development of this document was announced in the Administration's October 8,

statement on "Easing the Credit Crunch."

P's J-161a:
"The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans."

P's J-172a:
"AS WITH OTHER TYPES OF LOANS, COMMERCIAL REAL ESTATE LOANS THAT ARE ADEQUATELY PROTECTED BY THE CURRENT SOUND WORTH AND DEBT SERVICE CAPACITY OF THE BORROWER, GUARANTOR, OR THE UNDERLYING COLLATERAL GENERALLY ARE NOT CLASSIFIED."

THE MARCH 1, 1991 "REGULATORS ISSUE JOINT SUPERVISORY POLICIES" IS ATTACHED AS P'S K-193a.

THE APRIL 26, 1991 "UNIFORM AGREEMENT ON THE CLASSIFICATION OF ASSETS AND APPRAISAL OF SECURITIES" IS ATTACHED AS P's L-203a.

THE OCTOBER 8, 1991 STATEMENT OF SECRETARY NICHOLAS BRADY TITLED "EASING THE CREDIT CRUNCH TO PROMOTE ECONOMIC GROWTH" WHICH WAS DENIED ADMISSION IS ATTACHED AS P's M-210a.

THE OCTOBER 30, 1991 "DEPUTY SECRETARY JOHN E. ROBSON BEFORE SENATE COMMITTEE ON SMALL BUSINESS" WHICH WAS DENIED ADMISSION IS ATTACHED AS P's N-222a.

FDIC'S MEP, p.3.5-1, P's O-233a, ON OREO:
"EACH PARCEL OF OTHER REAL ESTATE IS TO BE REVIEWED AND CLASSIFIED ON ITS OWN MERITS. IN MAKING THAT JUDGMENT, THE EXAMINER WILL FIND IT NECESSARY TO:...4. REVIEW OTHER PERTINENT FACTORS, INCLUDING ... PRESENT OCCUPANCY, RENTALS, EXPENSES, ETC."

12 C.F.R. PART 323, APPRAISALS WITH AMENDMENTS, ARE IN P's P-238a, Q-322a, R-324a.

12 C.F.R. PART 363, ANNUAL INDEPENDENT AUDITS, P's S-429a.

STATEMENT OF THE CASE

This matter stems from a Petition for Review of a cease-and-desist order [C&D] issued by the FDIC after a bank examination of Petitioner on July 5, 1991. It is regrettable that the D.C. Circuit with all of its expertise in administrative law is so infected with the "S & L Syndrome" that it would not lend that expertise to a clarification of the significant banking law issues painfully and at great expense presented in detail so as to minimize the time to adequately judge them. Bank says this knowing that one-third of this Court are alumni of the D.C. Circuit. Bank thought that of all the Courts of Appeal, the D.C. Circuit would be the one to do just that, but it erred in failing to do so. That is exactly the minimal considera-

tion most courts treat this kind of subject, and which treatment Bank so desired to avoid. This case is one of national importance that cries for thoughtful decision. The classification of loans and OREO is the major problem of the FDIC and of some 11,000 commercial banks.

This is not an insolvent bank case as bank is rated well-capitalized with Tier 1 Capital to Risk-Weighted Assets of 14.11% which is 4.34 times the required 3.5%. Bank's other capital to asset ratios are more than 2 times the ratios required. All of this despite a depressed economy.

The FDIC and other bank regulators classify loans and OREO as "Passed", "Special Mention"[insufficient degree of risk to warrant adverse classification], "Substandard", "Doubtful"[requiring a 50% charge-off], and "Loss"[requiring a 100% charge-off] or in the alternative "Split the Classifications" among the aforegoing.

P's H-145a, I-155a. Bank objects to the substandard classifications. None of the lack of acts required by the C&D contributed to the classifications, so it is unmerited. As a result, however, the FDIC using its "Supervisory Evaluations" based on its wrongful classifications of loans and OREO has caused bank's annual deposit insurance premium to go from $113,192.25 to $339,583.70. Bank cannot find any case where a C&D was imposed on a well-capitalized bank. This is an attempt by the FDIC to micromanage this small bank which it is not authorized to do. Otherwise it is an act of vindictiveness because the bank will not kiss the FDIC's feet.

By Western standards this bank is an old bank being created in 1916. It merged with A.W. Skarda's bank in 1924 after the First National Bank of Clovis went into receivership in the 1922 depression. A.W. Skarda served as its Cashier for 16 years

and as President from 1940 until his death in 1967. Lynell G. Skarda, a son and counsel in this case, became a Director in 1959 and controlling stockholder in 1966 at which time his older brother, a former lawyer, also became a Director. Lynell became Chairman of the Board in 1968 and to date. A majority of the Board grew up in this bank. The President is the third director and is a former commissioned national bank examiner with some 20 years experience in banking. Bank has been operated with three Directors managing it day-to-day since 1968. From 1966 to July 5, 1991 bank has increased its capital from $1,102,800 to $18,814,000 - some $17,711,200 from earnings. Strangely, the ALJ did not think that was relevant.

Bank's three Directors became aroused when on July 5, 1991 a 28 year old Examiner-in-Charge [EIC] came in and started classifying as substandard loans and OREO

that had not been done so before. It is disconcerting to find out that you had been doing everything wrong for 75 years.

Bank complained then and now. At the outset the FDIC withdrew its substandard classification of a $605,000 loan to a Clovis auto dealer which was large enough to make all other classifications suspect.

Bank had a good Bank Manual, and although a Manual was not required, the FDIC charges required it to be changed. Yet, at the hearing the FDIC withdrew its criticisms on the Bank Manual as to funds management policy, asset/liability management strategy, and liquidity position. The Allowance for Loans and Lease Losses [ALLL] involving a simple bookkeeping transfer from the Undivided Profits and Capital Reserves Account to the ALLL Account and required charge-offs both were done before the EIC left as bank

had more than ample capital to do so. Although not required, the bank had a Watch List of its carefully watched loans containing all loans classified except two that bank disputes their classification. The payment of dividends was never a factor as bank was at all times well-capitalized. Renewing a note without payment of interest, i.e., capitalizing interest, was not prohibited by rule, regulation or policy, and was done only with amply secured loans.

On November 6, 1991, bank's Board of Directors met in Albuquerque, N.M. with Calvin B. Riddick, Assistant Regional Director of the Dallas,Texas FDIC Office, at which time bank offered him its "Response of The Citizens Bank of Clovis to Report of Examination as of July 5, 1991" that he refused to accept. Terry G. Youngblood, FDIC's attorney, then took it. This is a pregnant example of the

FDIC's lack of concern for the banks it regulates.

The parties stipulated to the objective verifiable facts on both loans and OREO. On loans only 9 were not fully collateralized of which 5 lacked only a very small amount, but which coupled with the borrowers Personal Statement [PS], i.e. Net Worth, exceeded the amount of the loan on all but 2. Of that 2, one was fully guaranteed by the John & Irene Garrett Estates with ample assets, and the other, Dean Eldridge, had sufficient assets in his solely owned Rochelle Corporation to pay the loan. Despite these stipulated objective and verifiable facts, the FDIC substandardized the entire loans rather than classifying them Special Mention at the worst or crediting the value of the collateral with a split classification. This resulted without foundation in a complete distortion of bank's condition.

The OREO was on bank's books at appraised values with one exception, the Arlington, Texas, parcel which had a realtor's listing value, and which bank had not been able to get an appraisal by anyone. Bank contends that the effective date of 12 C.F.R. Part 323, P's P-238a, requiring an appraisal by a State Certified or licensed appraiser had been extended to December 31, 1991, P's Q-322a, and later to December 31, 1992, 12 U.S.C.S. §3348(a), and that appraisals were not required because of exclusions in that regulation.

The largest OREO issue concerned the 8,400,000 bushels grain elevators that had been taken by bank in lieu of foreclosure as a result of a huge fraud by the Curry County Grain & Elevator Co., Inc. and its President, Malcolm G. Garrett, resulting in it being short some $5,000,000 in its accounts receivable and $1,786,250 in

grain inventory. The Garrett family had been customers of bank since 1932 controlling some 25,652 acres of mostly prime cultivated land. Mortgages had been taken on this land to reduce the individuals' debts to the elevators. Bank accepted a deed to the elevators with permission of the New Mexico Director of Financial Institutions, and with his permission leased to Pillsbury Co. who assigned such to Peavey Co., the grain division of ConAgra, Inc., the latter with income of over $20 billion a year. The elevators had not been classified substandard at the 1990 examination and had earned more in 1991 than in 1990. But at this 1991 examination they were substandardized despite that bank's lease was earning 9.07% on average book value with total yield of 12.97%, both of which yields were higher than bank could get in treasury bonds. P's J-184a.

In fact, if bank charged off all of the $8,400,000 of elevators on its books at stipulated objective and verifiable appraised value, bank would still be in compliance with all capital ratios required in 12 C.F.R. Part 325. Even the FDIC admits that it is perfectly legal for bank to hold and lease the elevators. Despite this, the FDIC classifies the entire book value as substandard rather than as Special Mention or splitting the classification.

In January and February of 1990 bank had started foreclosure on the Garrett family's 25,652 acres of land. On May 31, 1991 the court had issued its Decision Letter in bank's favor on all but some 7,400 acres of the John and Irene Estate Lands, the latter of which are awaiting an appeal in New Mexico's Supreme Court having been argued August 15, 1994. Despite these favorable decisions,

the FDIC substandardized all of the Garrett relationship of $4,038,000 plus $300,000 of D'Aun Garrett's fully secured loan in bankruptcy as substandard rather than Special Mention or splitting the classifications, P's I-155a. Bank's loss of mortgage foreclosure suits are so remote as to require a Special Mention classification rather than substandard.

There can be little question but that the FDIC Regional Office was relying on an anticipated ruling arising from the FDICIA provision, 12 U.S.C.S. §1831m(j), that banks with over $150 million in assets should have an independent audit committee that would require this little bank to add 3 directors. However, on June 2, 1993 the FDIC determined that only banks with assets of $500 million were subject to that provision. The C&D requirement is just not FDIC policy today.

Bank is upset at the violation of

5 U.S.C.S. §557(c) by the ALJ, P's C-20a, and its summary adoption by the FDIC, P's B-3a, in not ruling on each of bank's exceptions and giving the reasons or basis therefor on all matters of fact, law, and discretion presented on this voluminous record, P's D-71a. Just to say that the FDIC can do what it wants to do regardless of the stipulated objective and verifiable facts is not in conformity with the APA or due process.

This record is so replete with errors by the ALJ which were validated by the FDIC that it demands review.

EXISTENCE OF JURISDICTION BELOW

Bank petitioned the D.C. Circuit for review as specifically authorized by 12 U.S.C.S. §1818(h) which further provides for petition for certiorari to this Court.

REASONS FOR GRANTING THE WRIT

This Court has no decisions regarding

the classification of loans and OREO by bank regulators - the most important act they perform. What we in the banking industry call the "S & L Syndrome", i.e., fear of causing a loss to the bank insurance fund or becoming an addition to the notorious "Keating Five," pervades both the judicial and regulatory attitude toward banking issues. That attitude has resulted in the unmerited conclusion that the regulators unerringly are right in all matters because they have a self-anointed unfettered discretion. That is a conclusion which is totally wrong on the law and the fact. The very detail in these kinds of cases compels courts to avoid them like the plague, but in so doing they are denying statutory authorized due process to banks.

When one has a regulatory statement saying as in P's H-147a:

> "Substandard loans are inadequately protected by the current sound

> worth and paying capacity of the obligor or of the collateral pledged, if any."

Such is referring primarily to unsecured loans - that secured loans are a separate category. But when a subsequent regulatory enunciation saying as in P's J-172a:

> "As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or of the underlying collateral generally are not classified."

there can be no doubt that "worth and debt service capacity", "guarantor", and "underlying collateral" are in the disjunctive. This makes the definition clearly read:

> "Loans adequately protected by either the current sound worth and paying capacity of the obligor, guarantor, or of the underlyiny collateral, if any, generally are not classified."

The word "or" in the context of MEP,p.3.1-23 clearly designates alternatives or separate alternatives or separate categories.

First National Bank v. Dickinson, 396 U.S. 122, 135, 90 S.Ct. 337, 344, 24 L.Ed.2d 312(1969); Knutzen v. Eben Ezer Lutheran Housing Center, 815 F.2d 1343, 1349 (10th Cir., 1987). The FDIC reads this simple language as if "or" means "and" which requires both paying capacity "and" collateral. The FDIC's meaning is unsupported by a natural reading of its own provision.

The valuation of OREO under MEP, 3.5-1, P's O-233a and the "Uniform Agreement on Classification of Assets, etc.", P's L-203a, clearly requires such to be valued as loans. "Occupancy" and "Rentals" in addition to appraised values are considered, P's O-233a. The FDIC refuses to do other than classify OREO as an automatic substandard.

All that bank wants is for the FDIC to follow its own regulatory enunciations which it does not controvert it has to do.

CONFLICT WITH DECISIONS OF THIS COURT

The decision in this case conflicts with that in the recent case of O'Melveny & Myers v. FDIC, _U.S._, 114 S.Ct. 2048, _L.Ed.3d_(6/13/94). There the imputation of an S & L officer's fraud to the FDIC receiver was held to be determined by State law as "judicial creation of new 'federal common-law' causes of action to enrich the fund" was not merited "because there is no federal policy that the fund should always win." This Court further held that it was even less persuasive for the FDIC to contend that by so doing it would 'disserve the Federal program' of deposit insurance "thereby imposing costs 'on the nation's taxpayers'." Bank believes that this Court is telling the FDIC that the "S & L Syndrome" and fear of being labeled one of the "Keating Five" is not a sufficient basis to twist the fact because of a remote or minimal

chance that the insurance fund might be depleted. This is to say that the deference or discretion in FDIC's determinations where there are stipulated objective and verifiable facts cannot be founded on the principle that the FDIC should always be right. The D.C. Circuit's summary disposition of this matter cannot be supported on the wand of deference or discretion.

The D.C. Circuit's Judgment further conflicts with the opinion of this Court in Dimension Financial Corporation vs. Board of Governors of the Federal Reserve System, 474 U.S. 361, 105 S.Ct. 681, 88 L.Ed. 2d 691(1986) affirming 744 F.2d 1402 (10th Cir., 1984). The provisions in the FDI Act, 12 U.S.C.S. §1819, are almost a copy of those in the Bank Holding Company Act[BHCA]. 12 U.S.C.S. §1844(b) which was determined not to be "public good or public benefit" statute. Yet, Sunshine cites as its authority for examiners'

deference or discretion a railroad merger case under the ICC Act, Missouri-Kansas-Texas Railroad Company v. U.S., 632 F.2d 392(5th Cir.,1980), a divestiture case on daily newspapers, radio and T.V. stations under the FCC Act, FCC v. National Citizens Committee for Broadcasting, 436 U.S. 775, 56 L.Ed.2d 697(1978), and a nuclear waste disposal issue under the NRC, Baltimore Gas and Electric Co. v. National Resources Defense Council, Inc., 462 U.S. 67, 103 S.Ct. 2246, 75 L.Ed.2d 437(1983) the latter stating that the Commission was making predictions "at the frontiers of science." Examining this small bank is not on the frontiers of science. None of these "public interest or public benefit" cases apply to the classification of a bank's loans or OREO.

CONFLICT WITH DECISIONS OF OTHER COURTS APPEAL

The even more recent case of Seidman v. O.T.S., 37 F.3rd 911,(3rd Cir.,9/14/94)

disputes in depth the FDIC's principal authority, Sunshine State Bank v. FDIC, 783 F.2d 1580 (11th Cir.,1986), a Per Curiam opinion which held that "conclusions consist[ing] of objective verifiable facts requir[e] no particular training or expertise" but "the likelihood of a particular loan being repaid" does bring forth that extraordinary foresight which only bank examiners have. Sunshine misses the point in the case of secured loans as it is not whether the collateralized loan will be repaid, but rather will there be a loss in the collateral sufficient to effect the financial integrity of the bank.

Seidman, relying on Gulf Federal S & L Ass'n. v. Federal Home Loan Bank Board, 651 F.2d 259(5th Cir., 1981), holds that only acts which affect the financial integrity of an institution, not those that are remote or minimal, will consti-

tute an unsafe or unsound practice [U&U] sufficient to support a C&D.

The Seidman court cites Northwest National Bank v. U.S., 917 F.2d 1111(8th Cir.,1990) in which, although 4 years later, did not cite Sunshine State Bank, supra. Northwest was a bank with low capital and 30% of its loans not identified whereas bank here was well-capitalized with only 2 disputed loans out of 36 not on its Watch List. But to find deference or discretion in Northwest National, that court had to go to First National Bank of Eden v. Dept. Treasury, 568 F.2d 610(8th Cir.,1978) which in turn relied on Camp v. Pitts, 411 U.S.138, 93 S.Ct. 1241, 36 L.Ed.2d 106(1973) on bank chartering under 12 U.S.C.S. §27 a statute that does not require a hearing or a review of substantial evidence as within the exclusions of 5 U.S.C.S. §706(2)(E), and further relying on Dakota National Bank and Trust

Co. v. First National Bank and Trust Company, 554 F.2d 345(8th Cir.,1977), a branching case under 12 U.S.C.S. §36 similarly not requiring a hearing. Practically all of the cases on deference or discretion in classification of assets are based on the miscitation of bank chartering or branching cases under different statutes having no analogy to asset classification.

That the FDIC and other regulators simply are not entitled to the seemingly unfettered discretion indicated by the D.C. Circuit here and Sunshine State Bank, supra, is demonstrated by the following:

Anonymous v. FDIC, 617 F.Supp. 509 (D.C.,D.C. 1885) that the review of the removal of a bank officer was not a "formalistic exercise."

Dazzio v. FDIC, 970 F.2d 71(5th Cir., 1992) that under a statute saying the FDIC

may "in its discretion" modify a civil money penalty, the FDIC could not raise it on remand.

Oberstar v. FDIC, 987 F.2d 494 (8th Cir.,1993) on prohibiting an "institution-affiliated party" from engaging in banking activities under 12 U.S.C.S. §1818(e) which reads "Whenever the appropriate Federal banking agency determines" as compared with the here 12 U.S.C.S. §1818(b) which reads "If, in the opinion of the appropriate Federal banking agency" that court found that the imposition of a $125,000 civil money penalty based on his acceptance of a revocable proxy after Oberstar appealed the prohibition order was an abuse of discretion in that the "money penalty proceeding was commenced to punish Oberstar for seeking review of the Prohibition Order." "Looks to us uncomfortably like judicial vindictiveness." The C&D is "administrative

vindictiveness."

In Amberg v. FDIC, 934 F.2d 681(5th Cir. 1991) where the FDIC defaulted 5 bank directors on civil money penalties of $20,000 each and one for $10,000 after a request for hearing, but a late answer, Judge Garza in reversing stated "When deference is warranted, however, we will not bow our heads with closed eyes and walk away; rather we must still look at the actions complained of and see if they can be classified reasonable."

The decisions of the lower courts on the issue of classification of loans and OREO are nonconforming quilts of confused reasoning and miscitation.

IMPORTANT QUESTIONS OF FEDERAL LAW WHICH HAVE NOT BUT SHOULD BE SETTLED BY THIS COURT

The classification of loans and OREO by the FDIC is its most important function. The continuing neglect of adequate legal direction affects all commercial

banks and most S & Ls. Since the passage of the FDI Act in 1933 it is amazing that this mundane subject should after over 60 years be a case of first impression in this Court. It is essential to the banking industry that this Court decide the issues here raised.

THE SUMMARY DISPOSITION BY THE D.C. CIRCUIT IS SUCH A DEPARTURE FROM THE ACCEPTED AND USUAL COURSE OF JUDICIAL PROCEEDINGS AS TO CALL FOR THIS COURT'S EXERCISE OF ITS POWER OF SUPERVISION

That the D.C. Circuit either failed to recognize the importance of the issues here or felt that its docket did not allow the expenditure of time on the legal issues presented is not a proper excuse. It was bank's desire for the D.C. Circuit to examine these numerous issues that compelled it to petition that court rather than bank's resident court, all at great expense, in order to get definitive law on bank's rights. The summary disposition by the D.C. Circuit

of this seminal case is not something of which to be proud.

This Court could well remand this case with the direction that the D.C. Circuit be required to examine in depth the law applying to the classification of secured loans and appraised OREO and whether that and the other issues will support a C&D on a well-capitalized bank such as here.

CONCLUSION

This case meets every criterion in S.Ct. Rule 10. The law on classification of secured loans and appraised OREO is in a shambles. The FDIC is not empowered to issue a C&D because of acts, such as lack of a non-required bank manual, inspections, not transferring to the ALLL, capitalizing interest when secured, or lack of appraisals when not required, none of which affect the financial integrity of this well-capitalized bank. There is

nothing in the FDI Act or the FDIC's regulations, rules, policies, or interpretations that authorizes deference or discretion where you have stipulated objective and verifiable facts as here. Certiorari should be granted and the C&D vacated.

Respectfully submitted,

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PETITIONER'S APPENDIX

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APPENDIX A — JUDGMENT, NO. 94-1007

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 94-1007 **September Term, 1994**

Citizens Bank of Clovis, Petitioner

v.

Federal Deposit Insurance Corp., Respondent

Petition for Review of a Decision and Order
of the Federal Deposit Insurance Corporation

Before: Buckley, Williams and Sentelle, *Circuit Judges*.

JUDGMENT

This cause came to be heard on a petition for review of a decision and order of the Federal Deposit Insurance Corporation ("FDIC"). The issues have been accorded full consideration by the Court and occasion no need for a published opinion. See D.C. Cir. Rule 36(b).

Petitioner challenges the FDIC's decision and order of December 7, 1993. The FDIC found that petitioner had engaged in several "unsafe and unsound" banking practices within the meaning of 12 U.S.C. § 1818 (Supp. 1993) and issued a cease-and-desist order pursuant to its findings. Because we find no reversible error in the FDIC's findings, conclusions, and remedy, it is

ORDERED AND ADJUDGED, by the Court, that the petition for review is denied.

Appendix A

The Clerk is directed to withhold the issuance of the mandate herein until seven days after disposition of any timely petition for rehearing. See D.C. Cir. Rule 41(a).

Per Curiam

For the Court
s/ Ron H. Garvin
Ron H. Garvin, Clerk

Filed February 22, 1995

APPENDIX B — INTRODUCTION, DECISION AND ORDER ON CEASE AND DESIST PROCEEDING, NO. FDIC-91-406b

FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

In the Matter of

THE CITIZENS BANK OF CLOVIS
CLOVIS, NEW MEXICO

(Insured State Nonmember Bank)

DECISION AND ORDER ON CEASE AND DESIST PROCEEDING

FDIC-91-406b

INTRODUCTION

This is a proceeding initiated by the Federal Deposit Insurance Corporation ("FDIC") on December 19, 1991, seeking an Order to Cease-and-Desist against The Citizens Bank of Clovis, Clovis, New Mexico ("Respondent" or "Bank"). The alleged unsafe or unsound practices and violations of law, rule or regulation include inadequate loan policies, extending loan due dates without requiring additional collateral or payment of interest, maintaining an excessive volume of adversely classified loans, failing to maintain adequate reserves and poor management with insufficient supervision by the Bank's board of directors.

Administrative Law Judge Walter J. Alprin ("ALJ") held a hearing in this matter on March 16, 1993 through March 19, 1993, in Albuquerque, New Mexico. In his Recommended Decision[1] issued

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1. Citations to the record of this proceeding shall be as follows:

(Cont'd)

Appendix B

July 27, 1993, the ALJ concluded that Respondent had engaged in unsafe or unsound banking practices, and recommended issuance of an Order to Cease-and-Desist. Respondent filed exceptions to the ALJ's Recommended Decision.

DISCUSSION

After a thorough review of the record in this proceeding, the Board of Directors ("Board") of the FDIC agrees with the ALJ's findings and conclusions, and adopts and incorporates herein by reference the ALJ's Recommended Decision with two minor modifications[2]. The Board further finds that Respondent's exceptions lack merit — most merely reargue matters raised before and adequately addressed by the ALJ, or present assertions with no factual basis in the record.[3] The following exceptions

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(Cont'd)

Recommended Decision "R.D. at __."
Hearing Transcripts "Tr. vol. __ at __."
Bank's Exceptions "Except. at __."
Respondent's Exhibits "Resp. Ex. __."
Respondent's January 1, 1992 Discovery Request "Resp. Dis. __."

2. The Board makes the following two modifications: First, on page 19 of the ALJ's Recommended Decision, the sentence that begins on the second line, "Agency wants outside directors . . ." shall be modified by deleting the phrase "whose interests are not limited to banking." This phrase is replaced by "who have no connection to The Citizens Bank of Clovis other than their directorships."

Second, on page 40 of the ALJ's Recommended Decision, under the heading "VI. *Commentary*", the second sentence that begins "The term 'unsafe or unsound' " shall be modified by deleting the following phrase "is purposefully ambiguous." This phrase is replaced by "is an intentionally broad term."

3. The Bank excepts to the form and substance of virtually every statement (Cont'd)

merit Board comment.[4]

First, Respondent asserts, but fails to demonstrate, that the ALJ's Recommended Decision fails to comply with the Administrative Procedure Act ("APA"), 5 U.S.C. § 557(c), which states:

> "The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and shall include a statement of—
>
> (A) findings and conclusions, and the reasons or basis therefor, on all the material issues of fact, law, or discretion presented on the record; and
>
> (B) the appropriate rule, order, sanction, relief, or denial thereof."

Respondent does not support this exception with any specific material issue of fact, etc., that was allegedly not addressed by the

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(Cont'd)
and finding contained in the ALJ's Recommended Decision that does not present a positive view of the Bank's condition. The Bank disagrees with many of the findings concerning adverse classifications of its loans and assets, as well as the ALJ's conclusion that unsafe or unsound banking practices are present.

4. Any other exceptions not specifically mentioned here are rejected and deemed unnecessary to address because they reargue matters adequately covered by the ALJ or have no factual basis in the record.

ALJ. The Board has reviewed the entire record of this proceeding, including the ALJ's Recommended Decision, in light of this exception and finds no evidence of a failure to fully comply with the above provision. Accordingly, the Board rejects this exception as unsupported by the record.

Second, regarding the Bank's loan policies and procedures, Respondent excepts to the ALJ's alleged failure to point to a single instance where a loss was caused by anything contained in, or left out of the Bank's loan manual. The Bank also states that its manual "deals with every requirement of the Manual of Examination Policy" ("MEP"). Except. at 7. In focussing on the presence or absence of loss and compliance with the MEP, Respondent misses the point. The ALJ observed that much of the Bank's case "was spent proving that its banking practices did not violate any specific law, rule, or regulation."[5] However, 12 U.S.C. § 1818(b) also authorizes entry of a cease-and-desist order for commission of unsafe or unsound banking practices. R.D. at 40. The term "unsafe or unsound" is not limited to a few precisely prescribed practices. It is purposefully broad to allow discretion on a case-by-case basis to determine what practices pose an unnecessary risk to an institution and are contrary to prudent banking practices.[6] The ALJ concluded that FDIC proved

5. The ALJ's footnote No. 10 states as follows: "Respondent often argued that its banking practices did not violate the Manual of Examination Policies ("MEP") used by the FDIC as a guide in conducting its examinations. Bank examiner Jeffers testified that MEP is not a bible for all banks in determining safe banking practices but only a guide used in conducting bank examinations. Since many instances of unsafe or unsound banking practices may not be addressed in the MEP, Respondent's reliance on this guide is misplaced." R.D. at 40 n. 10.

6. *Hoffman v. FDIC*, 912 F.2d 1172, 1174 (9th Cir. 1990). Further, it is settled law that bank regulators' discretionary authority to define unsafe or unsound practices is to be "liberally construed." *Independent Bankers Association v. Heimann*, 613 F.2d 1164, 1169 (D.C. Cir. 1979)

the existence of unsafe or unsound practices "by the number of adversely classified loans, the weak underwriting practices, and insufficient comprehensive banking policies." R.D. at 40. The Board finds no weakness in the ALJ's analysis, and accordingly rejects this exception.

Third, the Bank excepts that, the "FDIC did not even produce" the Interagency Policies dated March 1, 1991, Resp. Ex. 3, the Uniform Agreement on the Classification of Assets and Appraisal of Securities of April 26, 1991, Resp. Ex. 3A, and a news release entitled: Regulators Issue Joint Supervisory Policy Statement of November 7, 1991, Resp. Ex. 6, Except. at 9. However, the Board's examination of the Bank's discovery request of January 7, 1992, the only one which contains any reference to these documents, only solicits copies of any documents that advise examiners concerning these policy statements. The underlying policy statements, however, are not requested.[7] Indeed, the Bank's references to these documents in the discovery request suggest that it already had copies of these news releases and published policy statements. In fact, the Bank had copies of these policy statements since they are in the record as Bank exhibits 3, 3A, and 6. Therefore, there can be no prejudice to the Bank by any failure to produce these documents.

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7. Each item that references one of these policy statements begins with the following language: "Produce all of the FDIC's documents and those of any other bank regulatory agency whose documents are possessed by the FDIC stating what examiners are expected to change in carrying out each of the policies enunciated in the March 1, 1991, Joint Agency News Release titled 'Regulators Issue Joint Supervisory Policies' and the 'General Statement' attached thereto. . . ." Resp. Dis. at 15, item 22.

Respondent's items that reference the other two policy statements and news releases are preceded with identical language. Resp. Dis; at 13, items 23 and 25.

Accordingly, the Board rejects this exception as not supported by the record.

Fourth, Respondent states "This court has no jurisdiction because of the willful failure of the FDIC to give the Bank a review of the July 5, 1991 Report of Examination by persons not in the review process." Except. at 12 and 34.[8] Respondent's jurisdictional argument is clearly erroneous. The FDIC's procedures for informal review specifically provides: "The use of this informal review process will not affect, delay, or impede any formal or informal supervisory or enforcement action in progress."[9] Thus, any alleged failure to grant informal review of the Bank's Report of Examination would have no affect, jurisdictional or otherwise, upon this enforcement action. Accordingly, the Board rejects this exception.

The Bank also states: "This court lacks jurisdiction because of the FDIC's erroneous holding that the Bank was not entitled to a private trial . . . ." Except. at 12. The Board rejects this exception as without merit. The Board's March 2, 1992 Decision states that the request for a private hearing was denied because the Bank

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8. Respondent cites to his exhibits 3, 3A, 6, and 7; Respondent's exceptions also state that "the reviewing person, Calvin B. Riddick, Assistant Regional Director in the FDIC's Regional Office in Dallas, Texas, admits that he did not read all of the Report of Examination and the Bank's policies, and therefore" the informal review was flawed. From the Board's review, the Assistant Regional Director merely testified that he did not review "line for line every page" of the July 5, 1991, Report of Examination. 4 Tr. vol. 4 at 105. Further, the Assistant Regional Director would not normally review the Bank's policies because they are not customarily attached to Reports of Examination.

9. Procedures for Requesting Review of Supervisory Decisions," Resp. Ex. 7.

failed to prove sufficient grounds under the statute, 12 U.S.C. § 1818(u)(2).

Finally, Respondent asserts that the ALJ erred in failing to admit, as an admission against interest, the Bank's Exhibit 67, a March 10, 1993, interagency policy statement on credit availability. The ALJ sustained objections to this exhibit because it was offered as a policy statement effective almost two years after the examination was conducted and over a year after this proceeding was initiated. The Board finds that it is not appropriate to apply a later adopted policy statement to the disputed issues in this proceeding.[10] Accordingly, the Board also rejects this exception.

CONCLUSION

The Board concludes that the record fully supports issuance of the Order to Cease-and-Desist recommended by the ALJ.

ORDER

The Board of Directors of the FDIC, having considered the entire record in this proceeding, hereby ORDERS that The Citizens Bank of Clovis, Clovis, New Mexico ("Bank"), and institution affiliated parties of the Bank cease-and-desist from the following unsafe or unsound banking practices and violations of laws, rules and regulations:

(a) Operating the Bank without adequate written loan policies and procedures;

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10. Moreover, Respondent did not argue that application of the policy statement to the loans at issue would be more favorable to it, nor could it because the policy statement does not change the standards for adversely classifying loans.

(b) Renewing or extending the due dates of loans without collecting interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest;

(c) Operating the Bank with an excessive level of adversely classified assets;

(d) Failing to provide an adequate allowance for loan and lease losses;

(e) Operating the Bank in violation of applicable Federal and state laws and regulations as more fully set forth on page 6-b of the Report of Examination of the Bank as of July 5, 1991;

(f) Engaging in hazardous lending and lax collection practices;

(g) Operating the Bank with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits; and

(h) Operating the Bank without adequate supervision and direction by the board of directors over the management of the Bank.

IT IS FURTHER ORDERED, that the Bank and institution affiliated parties of the Bank take affirmative action as follows:

1. Within 60 days after the effective date of this ORDER, the Bank shall revise, adopt, and implement written lending and collection policies and procedures to provide effective guidance

and control over the Bank's lending function. Such policies and their implementation shall be in a form and manner acceptable to the Regional Director, as determined at subsequent examinations, and shall include, at a minimum, the following:

(a) A provision that deviations from the written lending policies and procedures require approval of the board of directors of the Bank;

(b) A provision that establishes the lending limit of each loan officer;

(c) A requirement that extensions of credit shall not be refinanced, reworked, or renewed unless current financial information and documentation have been obtained;

(d) A requirement that all loans shall have written repayment understandings;

(e) A bank policy to address loans which are renewed or have their due dates extended without the full collection of interest thereon; such policy shall prohibit, except under specified circumstances, (i) the acceptance of separate notes in lieu of payment of interest, and ,(ii) the capitalization of interest to the balance of the note, which merely increases the original indebtedness;

(f) Limitations on the amount advanced in relation to the value of the collateral securing the credit and the documentation required by the Bank for each type of secured credit;

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(g) A provision specifically outlining the collection procedures to be taken by the Bank when borrowers fail to make timely payments;

(h) Guidelines for determining what rate of interest will be charged on all secured and unsecured loans; and

(i) A provision outlining the documentation required on all secured loans.

2. (a) Upon the effective date of the ORDER, the Bank shall, to the extent that it has not previously done so, eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss and one-half of the assets classified Doubtful by the FDIC as a result of its examination of the Bank as of July 5, 1991. Reduction of these assets through proceeds of loans made by the Bank shall not be considered "collection" for the purpose of this paragraph.

(b) Within 60 days after the effective date of this ORDER, the Bank shall submit a written plan to the Regional Director to reduce the remaining assets classified Doubtful and Substandard as of July 5, 1991. At a minimum, the plan shall include the following:

(i) A schedule providing quarterly goals to reduce the remaining adversely classified assets as of July 5, 1991, to levels which do not exceed a specified percentage of total equity capital and reserves, as reported each quarter by the Bank in its Consolidated Reports of Condition and Income and shall include no less than six consecutive quarterly target dates;

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(ii) An explanation showing the complete rationale used by the Bank in constructing the reduction schedule; and

(iii) A provision requiring, at a minimum, quarterly reviews by the Bank's board of directors whereby the extent of the Bank's compliance with the plan is expressly addressed, with the results of each review to be recorded in the corporate minutes of the board of directors.

(c) Upon written notice from the Regional Director that the submitted plan is not acceptable, the Bank shall, within 30 days after receipt of such notice, submit amendments to the plan to the Regional Director, including any modifications or amendments requested by the Regional Director. Upon written notice that the plan is accepted, it shall be adopted by the board of directors of the Bank. The Bank shall then immediately initiate measures detailed in the plan to the extent such measures have not been initiated.,

(d) For purposes of the plan, the reduction of the level of adversely classified assets as of July 5, 1991, to a specified percentage of total equity capital and reserves may be accomplished by:

(i) Charge-off;

(ii) Collection;

(iii) Sufficient improvement in the quality of adversely classified assets so as to warrant removing any adverse classification, as determined by the FDIC; or

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(iv) Increase of total equity capital and reserves.

(e) While this ORDER is in effect, the Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss as determined at any examination conducted by the FDIC or the State at such time as the report of examination is received by the Bank.

3. (a) Within 10 days from the effective date of this ORDER, the Bank shall increase its allowance for loan and lease losses ("allowance") to an adequate level.

(b) Thereafter, the Bank shall maintain its allowance in accordance with the prevailing requirements of the Instructions for the Consolidated Reports of Condition and Income ("Instructions"). Toward this end, within 60 days of this ORDER, the Bank's board of directors shall establish a comprehensive policy for determining the adequacy of the Bank's allowance. The policy shall provide for a review of the allowance at least once each calendar quarter. The review should focus on the results of the Bank's internal loan review, loan loss experience, trends of delinquent and non-accrual loans, an estimate of potential loss exposure on significant credits, concentrations of credit, and present and prospective economic conditions. The adequacy of the allowance in relation to the loss potential in the loan portfolio shall be reviewed by the Bank's board of directors, and adjustments to the allowance shall be made accordingly. Details of these reviews shall be incorporated into the minutes of the board of directors, including the methodology used to determine the adjustments.

4. Within 60 days after the effective date of this ORDER, the board of directors shall establish a loan review committee to

periodically review the Bank's loan portfolio and identify and categorize problem credits. The committee shall file a report with the board of directors. This report shall include the following information:

(a) The overall quality of the loan portfolio;

(b) The identification, by type and amount, of each problem or delinquent loan;

(c) The identification of all loans not in conformance with the Bank's lending policy; and

(d) The identification of all loans to officers, directors, principal shareholders, or their related interests.

At least 50 percent of the members of the loan review committee shall be directors not employed in any capacity by the Bank other than as a director.

5. After the effective date of this ORDER, the Bank, consistent with sound banking practices, shall eliminate and/or correct all violations of laws and/or regulations existing in the Bank as of July 5, 1991, as more fully set forth on page 6-b of the July 5, 1991 Report of Examination. In addition, the Bank shall ensure its future compliance with all applicable laws and regulations.

6. While this ORDER is in effect, the Bank shall neither declare nor pay, directly or indirectly, any cash dividend to shareholders without the prior written consent of the Regional Director.

Appendix B

7. (a) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower who has an extension of credit with the Bank that has been classified Loss, either in whole or in part, and is uncollected, or to any borrower who is already obligated in any manner to the Bank on any extension of credit, including any portion thereof, that has been charged off the books of the Bank and remains uncollected. The requirements of this paragraph shall not prohibit the Bank from renewing credit already extended to a borrower after full collection, in cash, of interest due from the borrower.

(b) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower whose extension of credit is classified Doubtful and/or Substandard, either in whole or in part, and is uncollected, unless the Bank's board of directors has signed a detailed written statement giving reasons why failure to extend such credit would be detrimental to the best interests of the Bank. The statement shall be placed in the appropriate loan file and included in the minutes of the applicable board of directors' meeting.

8. The Bank shall have and retain qualified management. Each member of management shall possess qualifications and experience commensurate with his or her duties and responsibilities at the Bank. The qualifications of management personnel shall be evaluated on their ability to: (i) comply with the requirements of the ORDER, (ii) operate the Bank in a safe or sound manner, (iii) comply with applicable laws and regulations, and (iv) restore all aspects of the Bank to a safe or sound condition, including asset quality, capital adequacy, earnings, management effectiveness, and liquidity. During the life of the

ORDER, the Bank shall notify the Regional Director in writing of any changes in management. The notification must include the name(s) and background(s) of any replacement personnel and must be provided prior to the individual(s) assuming the new position(s).

9. (a) Within 60 days after the date of this ORDER, the Bank shall prepare a plan for submission to the shareholders at their next meeting to reorganize the board of directors so that at least 50 percent of the members of the board shall be independent, outside directors as defined herein, during the life of this ORDER.

(b) For the purpose of this ORDER, an "outside director" shall be an individual:

(i) Who shall not be employed by the Bank or its affiliates other than as a director of the Bank or an affiliate;

(ii) Who shall not own or control more than 5 percent of the voting stock of the Bank or its holding company;

(iii) Who shall not be indebted to the Bank or any of its affiliates in an amount greater than 5 percent of the Bank's Part 325 Tier 1 capital or $500,000, whichever is less;

(iv) Who shall not be related to any director, principal shareholder of the Bank, or to any director or principal shareholder of any affiliate of the Bank; and

(v) Who shall be a resident of, or engage in business in, the Bank's trade area.

10. Within 60 days after the effective date of this ORDER, the board of directors shall establish a committee of the board of directors charged with the responsibility of ensuring that the Bank complies with the provisions of this ORDER. At least 50 percent of the members of such committee shall be outside directors as defined herein. The committee shall report monthly to the full board of directors, and a copy of the report of any discussion relating to the report or the ORDER shall be noted in the records of the board of directors. The establishment of this committee shall not diminish the responsibility or liability of the entire board of directors to ensure compliance with the provisions of this ORDER.

11. After the effective date of this ORDER, the Bank shall send to its shareholders, or otherwise furnish, a description of this ORDER (a) in conjunction with the Bank's next shareholder communication, and also (b) in conjunction with its notice or proxy statement preceding the Bank's next shareholder meeting. The description shall fully describe the ORDER in all material respects. The description and any accompanying communication, statement, or notice shall be sent to the FDIC, Registration and Disclosure Unit, 550 17th Street, N.W., Washington, D.C. 20429, for review at least 20 days prior to dissemination to shareholders. Any changes requested to be made by the FDIC shall be made prior to dissemination of the description, communication, notice, or statement.

12. Within 30 days after the end of the first calendar quarter following the effective date of this ORDER, and within 30 days after the end of each successive calendar quarter, the Bank shall

furnish written progress reports to the Regional Director detailing the form and manner of any actions taken to secure compliance with this ORDER and the results thereof. Such reports may be discontinued when the corrections required by this ORDER have been accomplished and the Regional Director has released the Bank in writing from making additional reports.

13. The effective date of this ORDER shall be 30 days after the date of its issuance. This ORDER shall be binding upon the Bank and all institution-affiliated parties of the Bank.

The provisions of this ORDER shall remain effective and enforceable except to the extent that, and until such time as, any provisions of this ORDER shall have been modified, terminated, suspended, or set aside by the FDIC.

By direction of the Board of Directors.

Dated at Washington, D.C., this 7th day of December, 1993.

s/ Robert E. Feldman
Robert E. Feldman
Deputy Executive Secretary

(SEAL)

APPENDIX C — RECOMMENDED DECISION, NO. FDIC-91-406b

UNITED STATES OF AMERICA
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

Docket No.
FDIC-91-406b

IN THE MATTER OF THE CITIZENS BANK OF CLOVIS CLOVIS, NEW MEXICO

(Insured State Nonmember Bank)

RECOMMENDED DECISION

(Issued July 27, 1993)

Appearances:

For the Federal Deposit Insurance Corporation:
Judith K. Sinclair, Esq.
Terry G. Youngblood, Esq.
Dallas, Texas

For the Respondent:
Lynell G. Skarda, Esq.
Clovis, New Mexico
Mickey D. Barnett, Esq.
Albuquerque, Texas

Appendix C

Before:

Walter J. Alprin
Administrative Law Judge
Office of Financial Institution Adjudication
Washington, D.C.

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I. PROCEDURAL HISTORY

On December 19, 1991, the Federal Deposit Insurance Corporation ("FDIC") initiated a Cease and Desist action against Respondent Citizens Bank of Clovis ("CBC" or "bank") pursuant to its authority under Section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b). FDIC alleges that CBC engaged in the following unsafe or unsound practices: operating with inadequate loan policies, extending loan due dates without additional collateral or cash, having excessive adversely classified loans and an inadequate allowance for loan or lease losses (ALLL), engaging in hazardous lending and lax collection practices, and having poor management and inadequate supervision by the Board of Directors. The Notice of Charges ("Notice") also alleges that CBC violated Part 323 of the FDIC Rules and Regulations, 12 C.F.R. § 323.1 et seq., concerning real estate appraisals.

Agency initiated this action as a result of an examination of CBC on July 5, 1991, conducted by both FDIC examiners and examiners from Financial Institutions Division of New Mexico. A hearing commenced before the undersigned in Albuquerque, New Mexico, on March 16, 1993 and concluded on March 19, 1993.

II. STATEMENT OF THE CASE

The relief sought by FDIC is the discontinuance of practices which are not prudent and constitute unsafe and unsound banking practices. These practices have led to excessive adversely classified loans, some of which have been and others of which may have to be charged off as a loss. Enforcement counsel attributes these practices to poor management. CBC is not

seriously undercapitalized, there is no threat of imminent insolvency, and neither of those circumstances is alleged by the FDIC. This proceeding primarily seeks to ensure the future safety of the institution, and hence of the Insurance Fund.

CBC questions the accuracy of the FDIC Examiner's adverse loan classifications. CBC maintains that it is a healthy institution and disputes that its practices have already caused or may cause loss to the Bank. CBC's position is that it is sufficient if its banking practices, alleged to be unsafe or unsound, do not violate specific written laws, regulations or any specific requirements formally established by the FDIC.

III. FINDINGS OF FACT

A. General

1. CBC is, and was at all relevant times a corporation existing and doing business under the laws of the State of New Mexico, having its principal place of business in Clovis, New Mexico, as a State nonmember bank insured by the Federal Deposit Insurance Corporation. It is, and has been at all relevant times subject to the rules and regulations and policies of the FDIC, and the laws of the State of New Mexico. (Stipulations 1 through 4.)[1]

2. CBC was inspected by a team of FDIC examiners as of the close of business on May 4, 1990 ("May 1990 Examination"), and a written Report of Examination was prepared. (Stipulation

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1. Stipulations admitted as ALJ Exhibit 2 are referred to as Stipulation No. __. Exhibits are indentified by the designation of the offeror, and number. Transcript pages are identified as "TR" followed by the volume number in Roman Numerals, coma, page number in Arabic numerals, as in "TR I, 21."

No. 5.) CBC was thereafter inspected by a team of FDIC examiners, of which Steven L. Jeffers ("Examiner") was Examiner-in-Charge, as of the close of business on July 5, 1991 ("July 1991 Examination"), and a written Report of the Examination was prepared. (Stipulation No. 6.)

3. In the ordinary course of their duties during the examinations, the FDIC examiners gathered information from CBC's records, including note and credit files and CBC's daily ledger, and from the CBC's management, for use in analysis of the bank's loans and other assets. (Stipulation No. 7.)

4. The July 1991, examination was conducted in accordance with the instructions, guidelines, standards and policies issued by the FDIC. (FDIC Ex. 15.)

5. The assignment of an adverse classification to an asset by an FDIC examiner is an expression of the degree of risk to CBC that a certain loan or other obligation owed to CBC will not be fully paid in accordance to its terms. (Vol. I, p. 17.)

6. "Other real estate," or "other real estate owned" (OREO) consists of all real estate, other than bank premises, actually owned by a bank and its consolidated subsidiaries. (Stipulation No. 10.)

7. "Overdue loans" are loans which are a minimum of 30 days past their maturity, or on which interest or principal is due and unpaid for a minimum of 30 days. (Stipulation No. 16(a).)

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B. Condition of CBC

8. The May 1990, Examination revealed adversely classified assets as follows:

Substandard	$ 13,228,000
Doubtful	$ -0-
Loss	$ 982,000
Total	$ 14,210,000

(FDIC Ex. 1, p. 2.)

9. The July 1991, Examination,[2] revealed adversely classified assets as follows:[3]

Substandard	$ 31,114,000
Doubtful	$ 403,000
Loss	$ 1,025,000
Total	$ 32,542,000

(Stipulation No. 21; FDIC Ex. 2, p. 2.) Before adverse classifications, total loans and leases at CBC equaled $100,464,000. (Stipulation No. 22; FDIC Ex. 2, p. 2.) In addition, total adversely classified loans and leases of $22,825,000 equaled 22.72 percent of total loans and leases (Stipulation No.

2. The Bank did not stipulate to the accuracy of asset classifications resulting in the ratios and numbers contained in Stipulations No. 23-42, but did stipulate that these ratios and numbers are the findings contained in the July 1991 Report with adjustments having been made to take into account the adjustment regarding the Big Country Ford, Inc. loans.

3. Results of the July 1991 Examination were adjusted to reflect the deletion of the Big Country Ford, Inc. Substandard classification in the amount of $605,000.

23; FDIC Ex . 2, p . 2), and overdue loans and leases equaled 11.12 percent of gross loans and leases. (FDIC Ex. 2, p. 2.)

10. At a bank without significant collection problems, the FDIC would expect the ratio of overdue loans and leases to gross loans and leases to be substantially less than 5 percent. (TR Vol. III, p. 29.)

11. As of July 5, 1991, CBC's total equity capital and reserves equaled $19,728,000. (Stipulation No. 31; FDIC Ex. 2, p. 3.) The bank had more than the minimum capital requirement, as its ratio of adversely classified assets to total equity capital and reserves equaled 164.95 percent (Stipulation No. 32 ; FDIC Ex. 2, p. 3-a) and its ratio of adversely classified assets to total assets was 20.31 percent. (Stipulation No . 33 ; FDIC Ex . 2, p . 2 .)

12. As of May 4, 1990, $1,831,000 or 14.34 percent of loans classified Substandard at the previous examination in July 1988 were classified Loss or had been charged off. (Stipulation No. 34; FDIC Ex. 1, p. 2-b.) Compared to this, $1,866,000 or 15.25 percent of loans classified Substandard at the May 1990 Examination were classified Loss or had been charged off. (Stipulation No. 35; FDIC Ex. 2, p. 2-b.)

13. As of July 5, 1991, the balance of the allowance for loan losses was $2,200,000. After adjusting the allowance for loan losses to subtract loans classified Loss and one-half of loans classified Doubtful as of July 5, 1991, the balance in the allowance for loan losses was $991,000. There was not sufficient provision in the allowance for loan losses for the remaining classified loans totaling $21,616,000 and unclassified loans totaling $77,639,000. (Stipulations No. 36((a), (b) and (c)).

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14. In the year ending December 31, 1990, CBC's net income was $826,000. (Stipulation No. 37; FDIC Ex. 2, p. 4). CBC's year-to-date earnings as of June 30, 1991, equaled a negative $131,000 prior to incorporating the results of the July 1991, Examination and a negative $2,596,000 after incorporating the results of the July 1991, Examination (Stipulation No. 38; FDIC Ex. 2, p. 4), indicating significant deterioration in income from May 1990 to July 1991. (TR Vol. I, p. 21; TR Vol. III, p. 27; FDIC Ex. 2, p. 2.)

15. The CBC's Uniform Composite Rating was 4 at the July 1991, Examination. (Stipulation No. 39.)

C. Written Policies on Loans and Investments

16. The CBC's written loan policies and procedures do not address the lending authority of each loan officer or members of the loan or executive committee (TR Vol. III, pp. 34-35); do not have adequate provisions for obtaining and reviewing real estate appraisals as well as reappraisals (FDIC Ex. 3); do not address appropriate and adequate collection procedures (TR Vol. III, pp. 40-41); do not address documentation required by CBC for each type of secured loan (TR Vol. III, p. 42); do not address a loan review and loan grading system (TR Vol. III, pp. 45-46); do not address written repayment understandings (TR Vol. III, pp. 36-38); do not address maintenance of an adequate allowance for loan losses (TR Vol. III, pp. 56-58); and, do not address procedures concerning deviations from the written lending policies and procedure (TR Vol. III, pp. 33-34-)

D. Capitalized Interest

17. During both the July 1991, Examination and the May

1990, Examination, CBC could not identify which specific loans had capitalized interest. (FDIC Ex. 2. Officers Questionnaire, Question No. 6, FDIC Ex. 1. Officers Questionnaire, Question No. 6.)

18. On or about August 30, 1989, CBC capitalized interest as follows:

(a). Capitalized interest upon renewal of a loan of $136,000 to The Rochelle Corporation which originated on or about June 30, 1988. This loan was classified Substandard at the July 1991. Examination. (Stipulation No. 44.) As of July 5, 1991, total debt of The Rochelle Corporation at CBC for various notes equaled $1,389,000. (Stipulation No. 47.)

(b) Capitalized $10,000 in interest at renewal of a loan to The Rochelle Corporation which originated on or about June 30, 1989 in the amount of $76,000. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 45.)

(c) Capitalized interest at the renewals of a loan to The Rochelle Corporation which originated on or about November 30, 1987, in the amount of $531,000. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 43.) At the time that CBC granted a loan to pay itself interest, the August 30, 1990, financial statement of The Rochelle Corporation indicated total assets of $1,653,000, total liabilities of $1,373,000, and a net worth of only $280,000. (Stipulation No. 46.)

(d) Granted a loan to Dean Eldridge in the amount of $256,000 to pay interest on loans at CBC to The Eldridge Companies and The Rochelle Corporation. This loan was

classified Substandard at the July 1991, Examination. (Stipulation No. 41; TR Vol. I, pp. 31-32.) At the time that CBC granted a loan to pay itself interest, Dean Eldridge's August 1990, financial statement indicated total liabilities of $264,000 and a negative net worth of $243,000 with contingent liabilities in excess of $1,000,000. (Stipulation No. 42.)

19. On or about February 27, 1991, CBC capitalized $800 in interest at renewal on a loan to Charles Hardisty. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 48.) On or about June 28, 1991, CBC granted a loan in the amount of $4,900 to Charles Hardisty to pay interest on another of his loans at CBC. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 49.) At the times that CBC granted loans to pay itself interest, Charles Hardisty's December 31, 1990, financial statement indicated total liabilities of $450,000 and a net worth of only $170,000. (Stipulation No. 50.)

20. On or about April 12, 1991, CBC capitalized approximately $1,000 in interest when renewing and consolidating three loans to Wilbur Johnson. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 54.) On or about June 26, 1991, CBC capitalized $3,000 in interest at renewal on a $32,000 loan to Wilbur Johnson. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 51.) On or about June 26, 1991, CBC capitalized $20,000 in interest at renewal on a $226,000 loan to Wilbur Johnson. This loan was classified Substandard at the July 1991, Examination. (Stipulation No. 53.) No financial information concerning Wilbur Johnson was in CBC's files as of July 5, 1991, to aid CBC in determining if advancing funds to pay itself interest was appropriate. (TR Vol. II, p. 110.)

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21. In 1990 and 1991, CBC granted three new loans to O.H. Pattison for the purpose of paying interest on a loan at CBC. During the July 1991 Examination these notes were reversed against current year income. (Stipulation No. 55.) At the time that CBC granted loans to pay itself interest, O.H. Pattison's October 1, 1990, financial statement indicated total assets of $1,172,000, total liabilities of $931,000 and a net worth of only $241,000. (TR Vol. I, p. 24.) O.H. Pattison's debt in the amount of $590,000 at CBC had been classified Substandard at the May 1990, Examination. (Stipulation No. 56; TR Vol. I, p. 36.)

22. On or about March 24, 1989, CBC capitalized $7,900 in interest at renewal of a loan to Westside Sheet Metal, Inc. Westside Sheet Metal, Inc.'s debt at CBC was classified Substandard at the May 1990 Examination. (Stipulation No. 60.) This loan was classified Substandard at the July 1991 Examination, based in part on a finding that Westside had a negative net worth of $660,000. (Stipulations No. 57, 58.)

23. John D. Wood's debt at CBC was classified Substandard at the May 1990 Examination. (Stipulation No. 64.) On or about December 27, 1990, CBC capitalized interest at renewal on a loan to John D. Wood. (Stipulation No. 61.)

E. Appraisals

24. On or about September 28, 1991, CBC renewed a loan to Wilbur Johnson in the amount of $226,000 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 66, 67.)

25. On or about September 28, 1990, CBC renewed a loan to Hager Sign Company in the amount of $185,500 which was

secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 68, 69.)

26. On or about February 27, 1991, CBC renewed a loan to Charles Hardisty in the amount of $96,600 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 70, 71.)

27. On or about March 29, 1991, CBC renewed another loan to Charles Hardisty in the amount of $165,600 which was also secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 72, 73.)

28. On or about June 28, 1991, CBC again renewed a loan to Charles Hardisty in the amount of $50,900 which was also secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 74, 75.)

29. On or about January 14, 1991, CBC renewed a loan to Valley Equipment and Fertilizer Co. in the amount of $127,000 which was secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loan. (Stipulations No. 76, 77.)

30. On or about June 28, 1991, CBC renewed a loan to O.H. Pattison in the amount of $548,000 which was secured by real estate, though CBC did not have acurrent or updated appraisal on the real estate securing the loan. (Stipulations No. 78, 79.)

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31. At various dates after September 1990, CBC renewed loans to Westside Sheet Metal, Inc. in amounts of $50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 80, 81.)

32. At various dates after September 1990, CBC renewed loans to The Rochelle Corporation in amounts of $50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 82, 83.)

33. At various dates after September 1990, CBC renewed loans to Calvin Stout in amounts of $50,000 or greater which were secured by real estate, though CBC did not have a current or updated appraisal on the real estate securing the loans. (Stipulations No. 84, 85.)

F. Management

34. CBC is owned by CBC, Inc., a one-bank holding company. Chairman of the Board Lynell G. Skarda owns 3,333 shares, or 66.66 percent, of CBC, Inc., and Director Langdon L. Skarda owns 1,647 shares, or 32.92 percent of CBC, Inc. (Stipulation No. 86.) The Board of Directors of CBC consists of Lynell G. Skarda, Langdon L. Skarda and Bank President Kent Carruthers. (Stipulation No. 87, TR Vol. III, p. 33.) CBC has no independent, outside directors. TR Vol. III, p. 64.)

35. CBC is controlled by Lynell and Langdon Skarda, and all major decisions including lending decisions at CBC are made by them. (FDIC Ex. 2 p. A-1 (Examiners Comments And Conclusions)).

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IV. DISCUSSION

There are, on the whole, no disputed issues of fact presented in this matter. The dispute in which CBC and the FDIC engage relates to the judgement of the Examiner, and of his Regional supervisors in supporting that judgment, in adversely classifying loans and criticizing the manner in which CBC is operated by the two sole controlling brothers. There is not even the issue of whether a supervisory action, such as a Memorandum of Understanding, rather than entry of a Cease and Desist Order, might be more appropriate.

12 U.S.C. § 1818(b)(1) provides in pertinent part that the FDIC may issue a cease & desist order if an institution is engaged in unsafe or unsound banking practices, or has violated a law, rule, or Regulation. Pursuant to 12 U.S.C. § 1818(b)(6) the FDIC may require affirmative action to correct conditions resulting from such practices or violations. Enforcement counsel in this instance seeks relief under § 1818(b)(6)(F) which authorizes FDIC to "take such other action" as it "determines to be appropriate."

The threshold issue in this proceeding is whether Citizens Bank of Clovis has engaged in unsafe or unsound banking practices, or violated any law, rule, or regulation. The second issue is whether the conduct alleged justifies the affirmative action sought by enforcement counsel in its proposed order. Each of the charges in the Notice will be carefully reviewed in turn to determine if the action constitutes an unsafe or unsound practice or a violation.

The phrase "unsafe or unsound practice" is not defined in section 8(b) of the Act, 12 U.S.C. § 1818(b). The statute also does

not specify practices which are deemed to be unsafe or unsound. Although not explained or clarified in the statute, the phrase has been commonly understood to mean the following:

> . . . [T]he term "unsafe or unsound practices" has a central meaning which can and must be applied to constantly changing factual circumstances. Generally speaking, an "unsafe or unsound practice" embraces any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk or loss or damage to an institution, its shareholders, or the agencies administering the insurance fund.

Financial Institutions Supervisory Act of 1966: Hearings on S. 3158 Before the House Committee on Banking and currency, 89th Congress., 2nd Sess., at 49-50 (1966).

There are primarily six areas of sound banking practice with which the FDIC wants CBC to comply. The Notice charges CBC with having (a) poor management, resulting in (b) an excessive amount of adversely classified loans and with (c) an inadequate Allowance for Loan and Lease losses, (d) continual involvement in the risky practice of capitalizing interest and (e) with violating 12 C.F.R. Part 323 regarding compliance with appraisal requirements. FDIC also alleges that CBC's (f) written loan and investment policies need to be more comprehensive.

Appendix C

A. MANAGEMENT

There are three members of the board of directors of CBC that also run the day-to-day management: President Kent Carruthers, Secretary of the Board Langdon Skarda and Chairman of the Board Lynell Skarda. The bank is wholly-owned by CBC, Inc. a one-bank 16 holding company. Lynell Skarda owns 66.7 percent of the holding company stock, Langdon Skarda owns 32.9, and Kent Carruthers owns the remaining fractional interest. Lynell Skarda became a director of CBC in 1960 and Langdon became a director in 1966. Kent Carruthers joined the bank as President on January 31, 1986 after having been employed by the Office of the Comptroller of the Currency from 1972 to 1977. Carruthers became a National Bank Examiner in 1975, and from 1977 to 1986 was employed as an officer at various banks.

CBC services a farm community and has been managed by the same two brothers for some thirty years. The management has much of their lives invested in this bank and controlling shareholder/chairman of the board/employee Lynell Skarda represented CBC at hearing. Lynell and Langdon Skarda and Kent Carruthers all wear many hats with respect to their participation in the affairs of CBC.

From the evidence presented at hearing, management has conducted business with the best interest of the bank in mind and, symbiotically, the continuing viability of CBC is also in the best interest of management whose livelihoods depend on the bank. There have been absolutely no allegations of personal impropriety, self-dealing or wrong-doing of any kind by management. CBC has remained adequately capitalized through difficult economic times where many other institutions have not survived.

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Management's polices and practices have served the bank adequately up to this point. However, FDIC has presented a solid case for necessary reforms to ensure the continued safety of CBC, and the continued safety of the Insurance Fund. The FDIC charges CBC with operating policies detrimental to CBC and thus constituting unsafe and unsound banking practices, including operating with poor management. Management received a 4 rating during the July 5, 1991 bank examination.[4] (TR Vol. III, p. 48; Vol IV, p. 132.)

FDIC alleges that management is not vigilant in monitoring its watch list, an internal document listing problem loans. During the hearing, the Examiner pointed out two significant loans, W.L. Lockmiller and Calvin Stout, that he felt should have been on the watch list and were not. Management strongly disagreed with the classifications of the above-mentioned loans.[5] With few exceptions, the Examiner found the loans adversely classified also to be on the bank's internal watch list.

In its proposed order, enforcement counsel does not seek to replace present management. Agency wants outside directors to be appointed to the board in addition to the existing directors, in order that the Board contain individuals whose interests are not

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4. The 4 assessment is a component of the CAMEL rating which is a composite of an institution's capital, asset, management, earnings, and liquidity. 1 is the highest rating and 5 is the lowsest.

5. CBC argues that Mr. Lockmiller is worth 3 million and is a sound credit risk and his loan should not be on the watch list and should not have been classified substandard. Agency's position is that funds were extended for start up costs on a failed business and went five years without a significant reduction. Further at the time of classification, there were no equipment inspections or livestock invoices to support Mr. Lockmiller's net worth. Vol. II, p. 24.

limited to banking. The request is not unreasonable and would add needed diversity to the Board of Directors.

B. ADVERSELY CLASSIFIED LOANS

The purpose of an adverse classification is to reveal the bank's weak assets and more accurately reflect the true condition of the institution. There are three categories of adversely classified loans: substandard, doubtful, or loss. Substandard assets have well-defined weaknesses that jeopardize the liquidation of the debt, but do not require the institution to make adjustments to its capital account. Loans classified doubtful are inadequately protected by the current sound worth and paying capacity of the obligor or collateral pledged, signifying that fifty percent of such assets are deducted from primary and total capital in analyzing the capital of the bank. Assets classified loss are charged off or deducted from stockholders equity in computing primary and total capital.

CBC's adversely classified assets increased by 133 percent from the 1990 bank examination to the 1991 examination. Adversely classified loans equal about 165 percent of the total equity capital and reserves as of the date of the July 5, 1991 examination. Calvin Riddick (Riddick), FDIC Assistant Regional Director for the FDIC Dallas Regional office, testified that generally the goal of sound banking practice is to prevent the total equity capital and reserves from exceeding 100 percent in order to protect the solvency of the bank. Riddick attributes the high level of adversely classified assets in CBC to a combination of economic conditions and unsafe or unsound banking practices.

CBC contends that the loans were misclassified by the FDIC Examiner at the July 1991 bank examination and that the

condition of the bank was thus misrepresented. CBC stipulates that the ratios and numbers contained in the July 1991 Report are the findings of the examiner but CBC does not stipulate to the accuracy of the asset classifications which give rise to the results. In fact, CBC argues that CBC used the Manual of Examination Policies (MEP) as guidance and could not have known that certain loans would be classified substandard, so that any examination finding unnoted classifications could not have conducted in accordance to FDIC policies and procedures.

At the hearing, CBC asked the Examiner why some of the loans classified substandard would not have been more appropriately classified special mention. Special mention loans are weak or deficient loans, but do not presently expose the bank to a sufficient degree of risk to merit an adverse classification and no adjustment to the capital account is necessary. The Examiner testified that in order for loans to be considered special mention a bank must have a well-conceived plan to work through the classifications. For instance, each credit's weaknesses would need to be acknowledged, and in working with the borrower a plan would have to be implemented to determine how much time to allow the borrower to perform. The testimony presented and evidence admitted at hearing was that CBC had no such plan of action and the loan files contained no such information.

CBC argues that many of the loans classified substandard are adequately collateralized. It maintains that loans secured with collateral equal to or valued slightly higher than the debt should not be classified substandard because the collateral is adequate to extinguish the debt and the bank will therefore not be exposed to risk of loss. If contemporary appraisals had been available and it had been known that the collateral's value truly was sufficient to extinguish the debt, an adverse classification would not have

been made. As the Examiner testified, however, the underlying collateral is only one factor to consider in examining risk of nonpayment:

> Well, first we look at the paying capacity of the borrower. We check performance. If the loan is past due, we would look at other sources of repayment through analysis of the financial statements and discussions with management. If the financial statements showed a highly leveraged position and no liquidity whatsoever, or minimal liquidity, then we look to the underlying collateral values.

(TR Vol. I, p. 39.) The Examiner testified that in his expert opinion collateral valued at 10 percent more than the amount owed the bank in an instance where the borrower is comparatively insolvent or has no cash flow, would generally justify a substandard classification (TR Vol. I, p. 57), and collateral not recently appraised is even more justification for an adverse classification. The Examiner further explained that experience shows that a financial statement not indicating any other source of repayment other than the real estate, signifies a well-defined weakness that can jeopardize the liquidation of the debt. CBC argues that the Manual of Examination Policies defines substandard to include loans adequately protected by either the current sound worth and paying capacity of the obligor or of the underlying collateral. As to CBC's loans, however, time and time again there were either no current appraisals of the property in the loan file, or even a complete lack of documentation, so that the current true value of the collateral in many instances was not known.

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The FDIC Examiner's loan classifications are entitled to deference, and will not be overturned unless shown to be arbitrary and capricious or outside a zone of reasonableness. *Sunshine State Bank v. Federal Deposit Ins. Corp.*, 783 F.2d 1580 (11th Cir. 1986). CBC did not effectively show why the adverse classifications were arbitrary or capricious, or unreasonable, or why the adversely classified loans actually were sound extensions of credit, and presented no testimony to contradict the findings, loan by loan, as testified to by the Examiner. The only contradictory evidence submitted was the opinion of CBC's President, Kent Carruthers who, despite his extensive experience, is not afforded the deference in making classifications of loans which is granted current FDIC Examiners. *In the Matter of The Stephens Security Bank*, FDIC-89-324b, 1 P-H-Enf. Dec. 5168 at A-1787 (1991). Rather than contradicting the Examiners' testimony, as shown in the Reports of Examination, cross-examination did no more than result in repetition of the testimony given on direct examination and support for the Reports of Examination. Stale and nonexistent appraisals could not support a claim of arbitrary or capricious classification. The Examiner's adverse classifications are a reasonable extrapolation from the circumstances found during the bank examination as shown by the undisputed facts of record. As demonstrated below, the bank examiner effectively discredited CBC's contention that the loans were improperly classified, and there is no basis upon which the undersigned could recommend revisiting the Examiner's classifications.

SPECIFIC LOANS

Many loans, such as the Dale Reichert loan and the West Side Sheet Metal loan, were adversely classified based in part on inadequate collateral security and in part on a past due status. (TR

Vol. I, p. 37-38.) The following are only some of the loans discussed at hearing:

1. A & M BUILDING SYSTEMS, INC. AND A & M FARM AND RANCH SUPPLY

Two problem loans are A & M building Systems, Inc. found to be substandard in the amount of $1,626,000, and A & M Farm and Ranch Supply, Inc. classified substandard in the amount of $972,000. (TR Vol. I, p. 29.) The Examiner testified that both businesses are in financial distress as evidenced by cash flow problems and operating losses.

As of July 31, 1990 to the time of the May 5, 1991, examination, its operating statement indicated that the A & M Farm & Ranch Supply lost $17,000. A & M Building System is secured by collateral valued just slightly over the loan. The debt is worth $1,626,000 and the collateral was last reported at $1,633,000. Vol. 1, p. 29. The Examiner testified that without any formal inspections of the collateral to determine an up to date appraisal, there is a substantial risk of loss to the bank in the event CBC closes the business. Vol. 1 p. 30. A & M building also had an overdraft in the amount of $153,000 evidencing its cash flow problem and is reported to have an insolvent position of $600,000.

2. ELDRIDGE COMPANIES AND ROCHELLE CORPORATION

Both the Eldridge Companies and the Rochelle Corporation have properties, parcels of real estate and mineral rights as collateral. (TR Vol. I, p. 31.) The loan files were not well documented and did not contain current appraisals on the

property, and some of the collateral had not been appraised for more than four years. The Examiner testified that the Rochelle Corporation was not able to pay $256,000 in accrued interest and a loan in that amount was granted to Deal Eldridge to cover the accrued interest. (TR Vol. I, p. 31.) The basic reason for the adverse classifications of the debt incurred by these businesses is the combined effect of their highly leveraged and illiquid financial statements, inappropriate capitalization of interest, and questionable values for the real estate securing the loans.

3. GARRETT RELATIONSHIP

The Garrett Relationship consists of loans made to D'Aun Garrett, Malcolm Garrett, Garrett Corporation, Garrett Farms and the Irene Garrett estate. The loans made to these entities were classified substandard and loss. The loans individually contained problems and risks but were assessed together as a whole. The aggregate collateral, approximately 25,000 acres of property, with inadequate or no appraisals, was valued at $4,838,000 while the debt from the Garrett Relationship totaled $5,173,000 resulting in a loss classification of $338,000. (TR Vol. II, p. 99.) The bank had no more than a second lien on some of the property used as collateral, and other property was encumbered by unpaid taxes. The balance of the whole debt was $5.1 million, of which $4 million was 611 days past due. (TR Vol. II, p. 100.) Over $4 million worth of assets of the Garrett relationship were, through no fault of CBC, not available because of litigation unrelated to the present administrative proceeding.[6] Ultimately, of the

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6. In 1986, CBC determined that Malcolm Garrett, a manager of the elevator, had diverted monies that were due on accounts receivable that were pledged to the bank. The bank never received those proceeds from the collections of those receivables in the amount of between 4 and 5 million. (TR Vol. IV, p. 145.) The bank was required to initiate a lawsuit to collect the funds. (TR Vol. II, p. 55.)

$5,173,000 currently on the books, $4,838,000 was substandard and $335,000 was assigned as loss. (TR Vol. I, p. 35.)

4. O.H. PATTISON

The O.H. Pattison loan was adversely classified because of inadequate collateral, poor performance and inappropriate capitalization of interest. (TR Vol. I, p. 37.) The loan was secured with a half interest in a feed mill, half interest in an ethanol plant and five and a half acres of un-appraised land. The estimated value of the total, tangible collateral was $385,000 and the debt equaled $673,000 resulting in a $163,000 classified as loss, $385,000 classified as substandard. The bank loaned Mr. Pattison $548,000 in 1987 for farm operating expenses and there has been no reduction on that loan. (TR Vol. I, p. 36.) Three additional notes for a total of $125,000 were made to cover the accrued interest on that large note. (TR Vol. I, p. 36.) The loan file was devoid of any equipment inspections whatsoever.

5. CURRY COUNTY GRAIN ELEVATOR

The Garretts originally owned and ran the Curry County Grain Elevator. In 1986, auditors for Curry County Grain determined that the inventory was overstated by almost $2 million. At that time the Commodity Credit Corporation, the entity regulating such elevators, had to decide whether to close down the elevator. The elevator had in excess of 6 million bushels of grain. CBC's position was that it wanted to keep the elevator afloat for the benefit of the community as well as for the bank's security in obtaining loan repayment. (TR Vol. IV, p. 147.) In 1987, the elevator was acquired by the bank. Curry County Grain Elevator was classified $8.4 million substandard during the 1991 bank examination.

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One criticism with this property is that the organization currently leasing the elevator, the Peavey Company, dictates the terms of the lease at each renewal, and obtains terms beneficial to the lessee and detrimental to CBC. For instance, the Peavey Co. demanded and obtained a change in lease payments so that it would retain the first $10,000 in profits, and that the bank's lease compensation, a pro-rata share profits, would be computed without considering the first $10,000. (TR Vol. I, p. 41.) The lease agreement is renewed on a six months basis and the lessee has the right to terminate the lease at expiration. (FDIC Ex. 2. at 2-a-24.) Most of the negotiating power is in the hands of the leasing organization and the banks income from the property is decreasing, leading the Examiner to conclude that the loan would not liquidate under the circumstances. (TR Vol. I, p. 40.) The property is classified substandard due to the declining amount of income generated, the likelihood of further reductions, the tenuous nature of the lease agreement, and the absence of timely liquidation. (FDIC Ex. 2 at 2-a-24.)

C. ALLOWANCE FOR LOAN AND LEASE LOSSES

Allowance for loan and lease losses (ALLL) provides a cushion for estimated losses in the loan portfolio. It is otherwise known as a loan valuation reserve and is a permanent segregation to the capital accounts. (TR Vol. I, p. 19.) It is an unsafe and unsound banking practice to allow the ALLL to become deficient; it must always have a credit balance to defend against loan and lease losses. If the allowance for loan and lease losses is under-funded, capital accounts would be considered overstated, and vice versa, and the true condition of the bank's capital would not be accurately reflected. (TR Vol. I, p. 109.)

The Examiner determined that the ALLL was deficient

based on the number of adversely classified loans. The total percent of adversely classified loans had risen from 13 percent at the 1990 examination to 23 percent at the 1991 bank examination. (TR Vol. I, p. 20.) Further, approximately 10.38 percent of gross loans were non-accrual and 11.12 percent of loans and leases were past due, so that the Examiner considered the past due ratio excessive. He further testified that it is basically a judgment call as to when banks should put money into the ALLL to keep it current (TR Vol. I, p. 111), but that, at a minimum, the ALLL should be scrutinized on a quarterly basis to determine whether or not additions need be made prior to the banks filing the quarterly reports. (TR Vol. IV, p. 129.) The Examiner pointed out that even if a bank is adequately capitalized and has sufficient capital surplus, undistributed profits, and the reserves necessary for protection of anticipated losses, by not properly segregating reserves the call report requirements would not be met and the report would inaccurately reflect the true state of the bank. As noted at the hearing, CBC's ability to correct the inadequate ALLL provision is fairly easy. CBC need only make a bookkeeping entry that is a reflection on the earnings performance of the bank. The Examiner noted that CBC's total risk based capital is above policy guidelines leading the undersigned to conclude that at the time of examination the bank was in no imminent danger of great loss.

D. CAPITALIZATION OF INTEREST

Capitalizing interest is not an unsafe or unsound banking practice in all circumstances. It is not imprudent if the total amount at risk is properly collateralized, or if there are other factors insuring service and repayment. If it is done inappropriately, however, it exposes the bank to unnecessary risk. Where a borrower is unable to pay the currently accrued

interest there is a significant question or doubt as to whether it will be able to pay the principal. In most instances if a borrower were ready, willing and able to service a debt and there were no cash flow problems then there would be no need for the bank to capitalize the interest.

SPECIFIC INSTANCES

The Examiner testified to the growing trend of CBC's practice of capitalizing interest. A fair number of specific instances of the practice were presented at hearing but only several examples are provided below and are indicative of the other instances and the general liquidity and cash flow problems of the borrowers.

1. JOHN D. WOOD

The John D. Wood loan is secured by collateral consisting of farm-related equipment. A $34,000 note exists with a $34,000 balance. The debt originated September 8, 1986 at $9,000 for operations and land payments. (TR Vol. II, p. 125.) During the course of five years a $9,000 note increased to $34,000 as follows: there was a $7,000 advance during September 1987; during April 1988, there was a $1,000 reduction; during June 1989, there was a $17,000 advance; during January 1990, there was a $1,500 reduction; on August 14, 1990, there was a $5,000 advance; on March 22, 1991, there was a $1,5000 reduction, to the current balance of $34,000. (TR Vol. II, p. 125.) There has been no collateral inspection performed for the equipment securing the loan. The continued capitalization of interest has been made on a debt secured with equipment valued solely on a property statement of December 6, 1990. Making loans collateralized by farm-related equipment, or any assets, the

current value of which is unknown to the bank, is an unsafe and unsound banking practice.

2. O.H. PATTISON

This loan, which originated in 1987, was in excess of $500,000 with no reduction at the time of the 1991 bank examination. The bank had loaned Pattison $125,000 in 1990 and 1991 to pay the accrued interest. (TR Vol. I, p. 25, and 59-60.)

3. W.L. LOCKMILLER

W.L. Lockmiller had a $371,000 debt consisting of nine notes, many of the which were renewed and had similar inherent risks. For example, Note Number 73725 originated at $32,000 on July 3, 1989. On September 5, 1989, the note was renewed with $40,000 of new funds advanced and on March 1, 1990, the note was renewed again with $25,000 advanced. From the time of origination, the note has never had any principal reduction. The loan file failed to contain the purpose of the debt and the use of the proceeds. (TR Vol. II, p. 20.)

4. DEAN ELDRIDGE

Dean Eldridge had a negative net worth and his business interests, Eldridge Companies and the Rochelle Corporation, were highly leveraged and illiquid. (TR Vol. 2, p. 33. The accrued interest could not be paid and the bank loaned Eldridge $256,000 to cover the interest. (TR Vol. I, p. 23.)

E. 12 C.F.R. PART 323

CBC is charged in the Notice with violating 12 C.F.R. Part

323, the only violation of a law, rule, or regulation which FDIC charges.[7] Section 323 of the Federal Deposit Insurance Corporation's Rules and Regulations requires a detailed appraisal to be performed on real estate loans in excess of a certain dollar amount, made or renewed after September 1990. The purpose of the regulation is to ensure the safety of federal financial and public policy interests in federally related real estate transactions[8] by mandating uniform, comprehensive appraisals in writing conducted by competent and supervised appraisers. A review of that Part of the Regulations will be useful.

The Part is entitled "Appraisals." It was published in the Federal Regulations, 55 FR 33888, on August 20, 1990, and except for Subsections .3(b) and (c), became effective September 19, 1990 as 12 C.F.R. § 323, with seven subsections, the first of which dealt with "Authority, purpose, and scope." Subsection .1(b)(1), dealing with purpose and scope, provides that:

> . . . Title XI (of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, FIRREA) provides protection for federal financial and public policy interests in real estate related transactions by acquiring real estate appraisals used in connection with federally related transactions be performed in

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7. Since the same facts underlying this charge have already been cited as evidence of unsafe and unsound practices, this charge is not of great importance herein. It should be ruled on, however, for precedential purposes.

8. Pursuant to 12 U.S.C. § 3350(4) "federally related transaction" is defined as any real estate transaction which a federal financial institutions regulatory agency or the Resolution Trust Corporation engages in, contracts for, or regulates and requires the services of an appraiser.

> writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. . . . (Parenthetical material added.)

Subsection .1(b)(2) provides that:

> This part: (i) identifies which real estate-related financial transactions require the services of an appraiser; (ii) Prescribes which categories of federally related transactions shall be appraised by a State certified appraise, and which by a State licensed appraised; and (iii) Prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the FDIC.

Subsection .4, entitled "Appraisal standards," provides in detail fourteen standards applicable to the minimal requirements of appraisals required by the Part. Subsections .5, .6 and .7 deal, respectively with the independence, and the competency of appraisers, and enforcement of requirements of the Part.

It is Subsection .3 which is said by CBC to confuse this proceeding as it pertains to allegation of violations of a Regulation. That Subsection is entitled "Appraisal not required; transactions requiring a State certified or licensed appraiser." Subsection .3(a), which went into effect on the original effective date, provides in part:

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> While supervisory guidelines, general banking practice or other prudent standards require an appropriate valuation of real property collateral, an appraisal performed in accordance with this part is not required for . . .

several specified circumstances, which are not of concern herein. Subsection .3(b) and (c), which did not become effective until January 1, 1993, detailed the transactions for which an appraisal must be provided by a "State certified appraiser" as opposed to the transactions which an appraisal could be provided by either a "State certified appraiser" or a "State licensed appraiser."[9] These provisions were thus not in effect during the period of the 1990 and 1991 examinations.

CBC takes the position that since Subsection .3(b) and .3(c) were not in effect, none of the other provisions of Part 323 were in effect. This is not so. The requirements of the minimum standards for appraisal of real property related to federal transactions were in effect, and those minimum standards at 12 C.F.R. § 323.4(a) were not met by CBC during the period of September 19, 1990 to the date of the last bank examination in May of 1992. To rule otherwise would be contrary to the clearly defined purpose of the Regulation, at 12 C.F.R. § 323.1(b)(1),to implement Title IX of FIRREA for the protection of federal financial and public policy interests in defined federally related real estate transactions through a system of written appraisals with specific requirements not at that time relating to state authorization of appraisers.

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9. It might be noted that nowhere in Part 323 is there a limitation that under appropriate circumstances the state authorizing the appraiser must be the state in which the real property is located, or the state in which the lending institution is located, or any other specific state or territory.

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F. LOAN AND INVESTMENT POLICIES

One of agency's greatest concerns for the future safety of CBC is its lack of adequate written loan policies. While CBC is currently no more than a three-man operation, with an extended Board of Directors it will be necessary for management to have written policies describing the manner in which operations are to be conducted, so that no employee exceeds his or her authority, or fails to perform his or her obligations.

1. COLLECTION PROCEDURES ON PAST DUE LOANS

CBC's collection procedures are insufficient to constitute safe or sound banking practices in that they are no more than that the loan officer should review the facts and meet with the bank's attorney and with the customer and determine if the borrower appreciates the problem. If the borrower does not realize that a problem exists, the bank should immediately require that the loan be paid in full. With bad loans, CBC's manual states that the bank can either try to rehabilitate the loan or try to collect the debt. The generalities are excellent, but the particulars are missing. As the Examiner put it,

> In other words, at what point in time when that loan becomes past due do you begin sending written notices or get on the phone and start calling? At what point do you strengthen those efforts and start sending Certified Mail? At what point do you go even further and send a demand notice? At what point do you actually decide that the borrower is not going to cooperate and go repossess the vehicle or foreclose on the property? (TR Vol 1. p. 36.)

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CBC explained that significant problem loans are presented to the board for proper resolution. This, however, merely shifts responsibility from loan officers to the Directors on an ad hoc basis, without providing specific guidance.

2. WRITTEN REPAYMENT PLAN

The purpose of a collection plan is that both lender and borrower have the same expectations with respect to repayment, or renewals, of loans. The risk involved in failing to prepare a written repayment plan is that lender may underestimate the credit worthiness of the borrower and not realize until CBC has already suffered loss, while the borrower may underestimate the intention of the lender to obtain timely payments of principal and interest. The Examiner testified that safe or sound practice require that there be a plan for orderly reduction of debt, specifically referring to the W.L. Lockmiller loan to show CBC's failure in implementing a payment plan, and its adverse effects. The use of the proceeds and the purpose of the debt for the most part were not documented, a note was renewed several times with a total of about $65,000 in additional cash advanced without a reduction in the principal and without an established payment plan. The Examiner also referred to the O.H. Pattison loan, with no payment plan, that was four years old and had been renewed several times with no reduction in principal.

3. COLLATERAL GUIDANCE

CBC lending policies were unsafe and unsound in failing to define when an appraisal should be documented. The bank has a number of agricultural loans and the underwriting for those were found to be lacking. Examples of such loans are O.H. Pattison, W.L. Lockmiller, and John Wood referred to previously. The

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Examiner commented on the need for specificity and detail in documentation, with this testimony that drive-by inspections of collateral such as livestock did not replace the need for written, comprehensive appraisals.

> If the collateral is cattle, you should do a periodic inspection. You know, check the brand of the cattle to make sure that it is indeed your cattle. Various things need to be documented such as, obviously, how many head you have, where the cattle are located, is it in a feed yard, is it on grassland or on wheat, the estimated pound per date growth. This all needs to be totaled up and multiplied by a market price per pound and an estimate given or compared against the current outstanding balance to determine your equity position.
>
> Similar procedures need to be done for crop production loans such as wheat. All this is done to adequately assess the risk in the loan portfolio and make appropriate provisions to the loan valuation reserve if necessary. (TR Vol. I, p. 44.)

CBC's present collateral guidance is insufficient. CBC's policy on collateral states that the ratio of loan amount to appraised value of collateral depends on the type of loan and that 50%-70% is considered to be a safe and prudent level in most instances. The provision fails to specify whether the margin should be different for different types of collateral such as cattle, grain, equipment or real estate, or to give details as to various types of collateral.

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4. GRADING SYSTEM

A watch list is a document identifying all loans adversely classified by the bank itself. CBC's internal loan review document indicates names, balances, and dates. Safe or sound banking practice requires an additional system of grading the risk factor, i.e. doubtful, substandard, or loss. If management is not aware of the degree of risk involved, its reserves may be underestimated.

5. DEVIATIONS FROM LOAN POLICY

Safe or sound banking policy requires a written policy that all loans deviating from standard written lending practices be approved by the board of directors, with a notation to that effect in board meeting minutes.

6. LENDING LIMIT AUTHORITY

Safe or sound banking practice requires a written specified lending limit authority for its loan officers. Dollar amount, type of loan — whether it be secured or unsecured, are factors to be included in the provision. CBC's present practice of having all loans approved by the board of directors rather than establishing lending limits again does no more than shift responsibility, and gives no real guidance to the loan officers accountable for arranging the loan.

7. SUPPORTING DOCUMENTATION

Failing to provide supporting documentation is an unsafe and unsound practice. The record is replete with instances of insufficient or no supporting documentation. Specific instances

have already been discussed above. CBC needs to implement more detailed bank provisions regarding underlying documentation of secured loans and unsecured loans. For instance, guidelines should be established regarding the necessity for a current financial statement indicating a borrower's income and expenses, the value of the collateral as evidenced by a recent comprehensive appraisal, and the borrower's equity in the collateral.

V. CONCLUSIONS OF LAW

1. The FDIC has jurisdiction over CBC and this action pursuant to the Act, 12 U.S.C. §§ 1811-18311, and the FDIC Rules and Regulations, 12 C.F.R. Chapter III.

2. At all times pertinent to this proceeding, CBC was an insured State nonmember bank within the meaning of sections 3(e)(2) and 8(b) of the Act, 12 U.S.C. §§ 1813(e)(2) and 1813(b), and section 308.01(i) of the FDIC Rules of Practice and Procedure, 12 C.F.R. § 308.01(i).

3. The FDIC has authority to issue an Order to Cease and Desist ("Order") against CBC pursuant to section 8(b) of the Act, 12 U.S.C. § 1818(b).

4. CBC has engaged in the following unsafe or unsound banking practices within the meaning of section 8(b) of the Act, 12 U.S.C. § 1818(b):

(a) Failing to have written loan policies and procedures which adequately articulate and describe prudent lending practices.

(b) Extending the due dates of loans or renewing loans without collection in cash of interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest.

(c) Failing to recognize and identify problem credits.

(d) Operating with an excessive volume of poor quality loans and loan related assets.

(e) Failing to provide an adequate reserve for loan losses which has the effect of misrepresenting and misstating the earnings of CBC.

(f) Violating Part 323 of FDIC Rules and Regulations, 12 C.F.R. Part 323, by renewing or extending loans without either (1) a current or updated appraisal or (2) a current or updated appraisal which did not comply with the requirements of Part 323.

(g) Operating with management, including the board of directors, whose practices and policies are detrimental to CBC and jeopardize the safety of its deposits.

9. In this action to issue an Order to Cease and Desist, the FDIC has satisfied all statutory requirements of section 8(b) of the Act, 12 U.S.C. § 1818(b).

VI. COMMENTARY

FDIC charges management with allowing unsafe or unsound banking practices to exist. The term "unsafe or unsound" is

purposefully ambiguous to allow agency greater discretion in determining on a case-by case basis what practices may pose an unnecessary risk to an institution and are contrary to commonly considered prudent banking practices. Much of CBC's case was spent proving that its banking practices did not violate any specific law, rule, or regulation.[10] However, the language of 1818(b) provides for entry of a cease and desist order for either a violation of statute, rule or regulation, or for unsafe or unsound practices.

The FDIC has effectively proven that unsafe or unsound practices did exist in part by the number of adversely classified loans, the weak underwriting practices, and insufficient comprehensive banking policies. Some of the inadequate banking practices may have been a result of those "constantly changing factual circumstances" expostulated to the Congress in 1966. What once was common and considered a safe banking practice may change over the thirty years of current management, and now constitute operations "which, if continued, would be abnormal risk or loss or damage" to the institution, its stockholders and depositors, and to the Insurance Fund.

While the agency does not have an absolutely free hand in shaping the relief to be granted, it does have "broad discretion in exercising its expertise in fashioning an appropriate remedy to stop the practice and/or violation, to prevent future such abuses

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10. Respondent often argued that its banking practices did not violate the Manual of Examination Policies ("MEP") used by the FDIC as a guide in conducting its examinations. Bank examiner Jeffers testified that MEP is not a bible for all banks in determining safe banking practices but only a guide used in conducting bank examinations. Since many instances of unsafe or unsound banking practices may not be addressed in the MEP, Respondent's reliance on this guide is misplaced.

and to correct the effect of the practice or violation." (Citations omitted.) *In the Matter of* ***, FDIC-84-23b and FDIC-84-67k, 1 P-H Enf. Dec. ¶ 5061 at A-720 (1986). The relief sought by the FDIC in this matter is relatively modest. Agency wants no more than to have CBC cease and desist from unsafe or unsound practices which will inure to its disadvantage and threaten the Insurance fund. FDIC is not demanding any capital infusion or seeking a penalty, but rather wants no more than a reform of CBC's banking practices and the ability to supervise these changes. Enforcement counsel has met its burden of proof by a preponderance of the evidence, and has effectively proven that the proposed changes are warranted.

VII. RECOMMENDED ORDER

Pursuant to the provisions of section 8(b) of the Federal Deposit Insurance Act, 12 U.S.C. § 1818(b), an Order in the form recommended and attached hereto and made a part hereof should issue against CBC. It is recommended that CBC be required to cease and desist from engaging in the unsafe or unsound practices, and violation of statute, as found herein, and to correct adverse conditions resulting therefrom.

s/ Walter J. Alprin
Walter J. Alprin
Administrative Law Judge
Office of Financial
Institution Adjudication

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PROPOSED ORDER

UNITED STATES OF AMERICA
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

Docket No.
FDIC-91-406b

IN THE MATTER OF THE CITIZENS BANK OF CLOVIS CLOVIS, NEW MEXICO

(Insured State Nonmember Bank)

ORDER TO CEASE AND DESIST

IT IS ORDERED, that The Citizens Bank of Clovis, Clovis, New Mexico ("Bank"), and institution-affiliated parties of the Bank cease and desist from the following unsafe or unsound banking practices and violations of laws and/or regulations:

(a) Operating the Bank without adequate written loan policies and procedures;

(b) Renewing or extending the due dates of loans without collection in case of interest due or obtaining adequate additional collateral to secure credit advanced for the purpose of paying interest;

(c) Operating the Bank with an excessive level of adversely classified assets;

(d) Failing to provide an adequate allowance for loan and lease losses;

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(e) Operating the Bank in violation of applicable Federal and state laws and regulations as more fully set forth on pages 6-b of the Report of Examination of the Bank as of July 5, 1991.

(f) Engaging in hazardous lending and lax collection practices;

(g) Operating the Bank with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits;

(h) Operating the Bank without adequate supervision and direction by the board of directors over the management of the Bank;

IT IS FURTHER ORDERED, that the Bank and institution-affiliated parties of the Bank take affirmative action as follows:

1. Within 60 days after the effective date of this ORDER, the Bank shall revise, adopt, and implement written lending and collection policies and procedures to provide effective guidance and control over the Bank's lending function. Such policies and their implementation shall be in a form and manner acceptable to the Regional Director, as determined at subsequent examinations, and shall include, at a minimum, the following:

(a) A provision that deviations from the written lending policies and procedures require approval of the board of directors of the Bank;

(b) A provision that establishes the lending limit of each loan officer;

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(c) A requirement that extensions of credit shall not be refinanced, reworked or renewed unless current financial information and documentation have been obtained;

(d) A requirement that all loans shall have written repayment understandings;

(e) Guidelines under which loans are renewed or have their due dates extended (i) Without full collection of interest thereon, (ii) by acceptance of separate notes in payment of interest, or (iii) by capitalization of interest to the balance of the note;

(f) Limitations on the amount advanced in relation to the value of the collateral securing the credit and the documentation required by the Bank for each type of secure credit;

(g) A provision specifically outlining the collection procedures to be taken by the Bank when borrowers fail to make timely payments;

(h) Guidelines for determining what rate of interest will be charged on all secured and unsecured loans; and

(i) A provision outlining the documentation required on all secured loans.

2. (a) Upon the effective date of the Order, the Bank shall, to the extent that it has not previously done so, eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss and one-half of the assets classified Doubtful by the FDIC as a result of its examination of the Bank as of July 5,

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1991. Reduction of these assets through proceeds of loans made by the Bank shall not be considered "collection" for the purpose of this paragraph.

(b) Within 60 days after the effective date of this ORDER, the Bank shall submit a written plan to the Regional Director to reduce the remaining assets classified Doubtful and Substandard as of July 5, 1991. At a minimum, the plan shall include the following:

(i) A schedule providing quarterly goals to reduce the remaining adversely classified assets as of July 5, 1991 to levels representing not more than a specified percentage of total equity capital and reserves as reported each quarter by the Bank in its Consolidated Reports of Condition and Income and shall include no less than six consecutive quarterly target dates;

(ii) An explanation showing the complete rationale used by the Bank in constructing the reduction schedule; and,

(iii) A provision requiring, at a minimum, quarterly reviews by the Bank's board of directors whereby the extent of the Bank's compliance with the plan is expressly addressed, with the results of each review to be recorded in the corporate minutes of the board of directors.

(c) Upon written notice from the Regional Director that the Submitted plan is not acceptable, the bank shall, within 30 days after receipt of such notice, submit amendments to the

plan to the Regional Director, including any modifications or amendments requested by the Regional Director. Upon written notice that the plan is accepted, it shall be adopted by the board of directors of the Bank. the Bank shall then immediately initiate measures detailed in the plan to the extent such measures have not been initiated.

(d) For purposes of the plan, the reduction of the level of adversely classified assets as of July 5, 1991, to a specified percentage of total equity capital and reserves may be accomplished by:

(i) Charge-off;

(ii) Collection;

(iii) Sufficient improvement in the quality of adversely classified assets so as to warrant removing any adverse classification, as determined by the FDIC; or

(iv) Increase of total equity capital and reserves.

(e) While this ORDER is in effect, the Bank shall eliminate from its books, by charge-off or collection, all assets or portions of assets classified Loss as determined at any examination conducted by the FDIC or the State at such time as the report of examination is received by the Bank.

3. (a) Within 10 days from the effective date of this ORDER, the Bank shall increase its allowance for loan and lease losses ("allowance") to an adequate level.

(b) Thereafter, the Bank shall maintain its allowance in accordance with the prevailing requirements of the Instructions for the Consolidated Reports of Condition and Income ("Instructions"). Toward this end, within 60 days of this ORDER, the Bank's board of directors shall establish a comprehensive policy for determining the adequacy of the Banks allowance. The policy shall provide for a review of the allowance at least once each calendar quarter. The review should focus on the results of the Bank's internal loan review, loan loss experience, trends of delinquent and non-accrual loans, an estimate of potential loss exposure on significant credits, concentrations of credit, and present and prospective economic conditions. The adequacy of the allowance in relation to the loss potential in the loan portfolio will be reviewed by the Board of Directors, and adjustments to the allowance will be made accordingly. Details of these reviews will be incorporated into the minutes of the Board of Directors, including the methodology used to determine the adjustments.

4. Within 60 days after the effective date of this ORDER, the board of directors shall establish a loan review committee to periodically review the Banks loan portfolio and identify and categorize problem credits. The committee shall file a report with the board of directors. This report shall include the following information:

(a) The overall quality of the loan portfolio;

(b) The identification, by type and amount, of each problem or delinquent loan;

(c) The identification of all loans not in conformance with the Bank's lending policy; and

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(d) The identification of all loans to officers, directors, principal shareholders or their related interest.

At least 50 percent of the members of the loan review committee shall be directors not employed in any capacity by the Bank other than as a director.

5. After the effective date of this ORDER, the Bank, consistent with sound banking practices, shall eliminate and/or correct all violations of laws and/or regulations existing in the Bank as of July 5, 1991, as more fully set forth on page 6-b of the July 5, 1991 Report of Examination. In addition, the Bank shall ensure its future compliance with all applicable laws and regulations.

6. While this ORDER is in effect, the Bank shall neither declare nor pay, directly or indirectly, any cash dividend to shareholders without the prior written consent of the Regional Director.

7. (a) While this ORDER is in effect, the Bank shall not extend, directly or indirectly, any additional credit to or for the benefit of any borrower who has an extension of credit with the Bank that has been classified Loss, either in whole or in part, and is uncollected, or to any borrower who is already obligated in any manner to the Bank on any extension of credit, including any portion thereof, that has been charged off the books of the Bank and remains uncollected. The requirements of this paragraph shall not prohibit the Bank from renewing credit already extended to a borrower after full collection, in cash, of interest due from the borrower.

(b) While this ORDER is in effect, the Bank shall not

extend, directly or indirectly, any additional credit to or for the benefit of any borrower whose extension of credit is classified Doubtful and/or Substandard, either in whole or in part, and is uncollected, unless the Banks board of directors has signed a detailed written statement giving reasons why failure to extend such credit would be detrimental to the best interests of the Bank. The statement shall be placed in the appropriate loan file and included in the minutes of the applicable board of directors' meeting.

8. The Bank shall have and retain qualified management. Each member of management shall possess qualifications and experience commensurate with his or her duties and responsibilities at the Bank. The qualifications of management personnel shall be evaluated on their ability to: (i) comply with the requirements of the ORDER, (ii) operate the Bank in a safe or sound manner, (iii) comply with applicable laws and regulations, and (iv) restore all aspects of the Bank to a safe or sound condition, including asset quality, capital adequacy, earnings, management effectiveness, and liquidity. During the life of the ORDER, the Bank shall notify the Regional Director in writing of any changes in management. The notification must include the name(s) and background(s) of any replacement personnel and must be provided prior to the individual(s) assuming the new position(s).

9. (a) Within 60 days after the date of this ORDER, the Bank shall prepare a plan for submission to the shareholders at their next meeting to reorganize the board of directors either by increasing the number of directors or by appointing new directors so that for so long as their ORDER is outstanding at least 50 percent of the members of the board shall be independent, outside directors as defined herein.

(b) For the purpose of this ORDER, an "outside director" shall be an individual:

(i) Who shall not be employed by the Bank or its affiliates other than as a director of the Bank or an affiliate;

(ii) Who shall not own or control more than 5 percent of the voting stock of the Bank or its holding company;

(iii) Who shall not be indebted to the Bank or any of its affiliates in an amount greater than 5 percent of the Bank's Tier 1 capital or $500,000 whichever is less;

(iv) Who shall not be related to any director, principal shareholder of the Bank or to any director or principal shareholder of any affiliate of the Bank; and

(v) Who shall be a resident of, or engage in business in, the Bank's trade area.

10. Within 60 days after the effective date of this ORDER, the board of directors shall establish a committee of the board of directors charged with the responsibility of ensuring that the Bank complies with the provisions of this ORDER. At least 50 percent of the members of such committee shall be outside directors as defined herein. The committee shall report monthly to the full board of directors; and, a copy of the report of any discussion relating to the report or the ORDER shall be noted in the records of the board of directors. The establishment of this committee shall not diminish the responsibility or liability of the

entire board of directors to ensure compliance with the provisions of this ORDER.

11. After the effective date of this ORDER, the Bank shall send to its shareholders or otherwise furnish a description of this ORDER, (a) in conjunction with the Bank's next shareholder communication, and also (b) in conjunction with its notice or proxy statement preceding the Bank's next shareholder meeting. The description shall fully describe the ORDER in all material respects. The description and any accompanying communication, statement, or notice shall be sent to the FDIC, Registration and Disclosure Unit, 550 17th Street, N.W., Washington, D.C. 20429, for review at least 20 days prior to dissemination to shareholders. Any changes requested to be made by the FDIC shall be made prior to dissemination of the description, communication, notice, or statement.

12. Within 30 days after the end of the first calendar quarter following the effective date of this ORDER, and within 30 days after the end of each successive calendar quarter, the Bank shall furnish written progress reports to the Regional Director detailing the form and manner of any actions taken to secure compliance with this ORDER and the results thereof. Such reports may be discontinued when the corrections required by this ORDER have been accomplished and the Regional Director have released the Bank in writing from making additional reports.

13. The effective date of this ORDER shall be 30 days after the date of its issuance. This ORDER shall be binding upon the Bank and all institution-affiliated parties of the Bank.

The provisions of this ORDER shall remain effective and enforceable except to the extent that, and until such time as, any

provisions of this ORDER shall have been modified, terminated, suspended, or set aside by the FDIC.

By Order of the Board of Directors.

Dated at Washington, D.C., this __ day of __ 1993.

Hoyle L. Robinson
Executive Secretary

CERTICATE OF SERVICE

I hereby certify that on July 27, 1993, I caused a true copy of the above to be served by Federal Express overnight express mail on the following:

Lynell G. Skarda, Esquire
Citizens Bank Building
P.O. Box 400
Clovis, New Mexico 88101

Mickey D. Barnett, Esq.
10200 Menaul, N.E.
Albuquerque, NM 87112

Judith K. Sinclair
Regional Counsel (Supervision)
Terry Youngblood, Esq.
1910 Pacific Avenue
Suite 1900
Dallas, Texas 75201

and by hand to the office of:

Robert E. Feldman
Deputy Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Arthur L. Beamon
Associate General Counsel
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

s/ Walter J. Alprin
Walter J. Alprin

APPENDIX D — THE CITIZENS BANK OF CLOVIS' EXCEPTIONS TO THE A.L.J.'S RECOMMENDED DECISION, FINDINGS, CONCLUSIONS, PROPOSED ORDER, ADMISSION AND EXCLUSION OF EVIDENCE, FAILURE OF THE A.L.J. TO MAKE RULINGS PROPOSED BY RESPONDENT AS REQUIRED BY 12 C.F.R. § 308.39, NO. FDIC-91-406b

Note: This document is the same as the original except that citations to the transcript of testimony in I Volume of Exhibits have been substituted for those in the original transcript.

UNITED STATES OF AMERICA
FEDERAL DEPOSIT INSURANCE CORPORATION
WASHINGTON, D.C.

Document Number
FDIC-91-406b

In the Matter of

THE CITIZENS BANK OF CLOVIS CLOVIS, NEW MEXICO

(Insured State Nonmember Bank)

THE CITIZENS BANK OF CLOVIS' EXCEPTIONS TO THE A.L.J.'S RECOMMENDED DECISION, FINDINGS, CONCLUSIONS, PROPOSED ORDER, ADMISSION AND EXCLUSION OF EVIDENCE, FAILURE OF THE A.L.J. TO MAKE RULINGS PROPOSED BY RESPONDENT AS REQUIRED BY 12 C.F.R. § 308.39

The Citizens Bank of Clovis, Respondent, states its exceptions to the Administrative Law Judge's holdings as provided in 12 C.F.R. §308.39 as follows:

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1. All documents prepared by the A.L.J. are inadequate totally in failing to comply with the Administrative Procedure Act [APA], 5 U.S.C.S. §557(c), which states:

> "The record shall show the ruling on each finding, conclusion, or exception presented. All decisions, including initial, recommended, and tentative decisions, are a part of the record and *shall,* include a statement of-
>
> (A) findings and conclusions, and the reasons or basis therefor, on *all* the material issues of fact, law or discretion presented on the record; and
>
> (B) the appropriate rule, order, sanction, relief, or denial thereof." (Emphasis writer's).

The purpose of this statute is to provide the courts, and there will be a court, with a basis for judicial review - with an intelligent statement of the factors considered, issues decided and reasons supporting the conclusions. *Hyatt Corp. v. N.L.R.B., 939 F.2d 361, 367 (Cir. 6., 1991); Flavo-O-Rich Inc. v. N.L.R.B., 531 F.2d 358, 361 (Cir. 6, 1976), c.d. 430 U.S. 966, 97 S.Ct. 1674, 52 L.Ed.2d 358; Re Boston & P.R. Corp., 428 F.2d 159, 164 (Cir. 1, 1970).* It exists to offer a degree of protection from unrestrained and unwarranted bureaucratic action. *Bell Lines v. U.S., 263 F.Supp. 40 (S.D. W.Va., 1967).* This Bank earnestly believes that is to what it is being subjected.

2. Bank excepts to each and every statement or holding or

conclusion in the A.L.J.'s Recommended Decision and Order to Cease and Desist except the following which are true as far as each goes:

a. Page 4 of II Statement of the Case:

> "CBC is not seriously undercapitalized, there is no threat of imminent insolvency . . . . CBC questions the accuracy of the FDIC Examiner's adverse loan classifications. CBC maintains that it is a healthy institution and disputes that its practices have already caused or may cause loss to the Bank. CBC's position is that it is sufficient if its banking practices, alleged to be unsafe or unsound, do not violate specific written laws, regulations or any specific requirements of the FDIC."

b. Page 4 of III Findings of Fact:

Par.1:	Bank is a New Mexico corporation.
Par.2,p.5:	Bank was examined July 5, 1991.
Par.3,p.5:	Examiners looked at Bank's records.
Par.6,p.6:	Definition of OREO.
Par.11,p.7:	"As of July 5, 1991, CBC's total equity capital and reserves equaled $19,728,000. (Stipulation No. 31; FDIC Ex.2,p.3.). The bank had more than the minimum capital requirement. . . ."

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Par.18-23,p.9-12: Loans where interest was capitalized are correct as to amounts not reasons.

Par.24-33,p.12-14: Appraisals' lack are correct as to names and amounts not reasons.

Par.34-35,p.14-15: Bank is managed by Skarda brothers.

Page 16-17,A. Management: There are three members of the board of directors of CBC that also run the day-to-day management: President Kent Carruthers, Secretary of the Board Langdon Skarda and Chairman of the Board Lynell G. Skarda. The bank is wholly-owned by CBC, Inc., a one-bank holding company. Lynell Skarda owns 66.7 (sic) percent of the holding company stock, Langdon Skarda owns 32.9 (sic), and Kent Carruthers the remaining fractional interest. Lynell Skarda became a director of CBC in 1960 (sic 1959) and Langdon Skarda became a director in 1966. Kent Carruthers joined the bank as President (sic) on January 31, 1986 after having been employed by the Office of the Comptroller of Currency from 1972 to 1977. Carruthers became a National Bank Examiner in 1975, and from 1977 to 1986 was employed as an officer at various banks.

CBC services a farm community and has been managed by the same two

brothers for some thirty years. The management has much of their lives invested in this bank controlling shareholder/chairman of the board . . . Lynell Skarda represented CBC at the hearing. Lynell and Langdon Skarda and Kent Carruthers all wear many hats with respect to their participation in the affairs of CBC.

From the evidence presented at hearing, management has conducted business with the best interest of the bank in mind and, symbiotically, the continuing viability of CBC is also in the best interest of management whose livelihoods depend on the bank. There have been absolutely no allegations of personal impropriety, self-dealing or wrong-doing of any kind by management. CBC has remained adequately capitalized through economic times where many other institutions have not survived.

Management's policies and practices have served the bank adequately up to this point. . . . During the hearing, the Examiner pointed out two significant loans, W. L. Lockmiller and Calvin Stout, that he felt should have been on the watch list and were not. Management strongly disagreed with the classifications of the above-mentioned loans. With few

exceptions, the Examiner found the loans adversely classified also to be on the bank's internal watch list. N.7 "CBC argues that Mr. Lockmiller is worth $3 million and is a sound credit risk and his loan should not have been on the watch list and should not have been classified substandard. . . ."

Page 19: "In its proposed order, enforcement counsel does not seek to replace management."

Page 20: "CBC contends that the loans were misclassified by the FDIC Examiner at the July 1991 bank examination and that the condition of the bank was thus misrepresented. CBC stipulates that the ratios and numbers contained in the July 1991 Report are the findings of the examiner but CBC does not stipulate to the accuracy of the asset classifications which gave rise to the results. In fact, CBC argues that CBC used the Manual of Examination Policies (MEP) as guidance and could not have known that certain loans would be classified substandard, so that any examination finding unnoted classifications could not have conducted in accordance to FDIC policies and procedures.

At the hearing, CBC asked the

Examiner why some of the loans classified substandard would not have been more appropriately classified special mention."

Page 21: "CBC argues that many of the loans classified substandard are adequately collateralized. It maintains that loans secured with collateral equal to or valued slightly higher than the debt should not be classified substandard because the collateral is adequate to extinguish the debt and the bank will therefore not be exposed to risk of loss."

Page 25: "Over $4 million worth of assets of the Garrett relationship were, through no fault of CBC, not available because of litigation unrelated to the present administrative proceeding. . . ." N.6. "In 1986, CBC determined that Malcolm Garrett, a manager of the elevator, had diverted monies that were due on accounts receivable that were pledged to the bank. The bank never received those proceeds from the collection of those receivables in the amount of between $4 and $5 million."

Page 26: "The Garretts originally owned and ran the Curry County Grain Elevator. In 1986, auditors for Curry County Grain determined that the inventory was overstated by almost $2 million. At the time the Commodity Credit Corporation,

the entity regulating such elevators, had in excess 6 million bushels of grain. CBC's position was that it wanted to keep the elevator afloat for the benefit of the community as well as for the bank's security in obtaining loan repayment. . . . In 1978 (sic) the elevator was acquired by the Curry County Grain Elevator and was classified $8.4 million substandard during the 1991 bank examination."

Page 28: "As noted at the hearing, CBC's ability to correct the inadequate ALLL provision is fairly easy. CBC need only make a bookkeeping entry that is a reflection on the earnings performance of the bank.

The Examiner noted that CBC's total risk based capital is above policy guidelines leading the undersigned to conclude that at the time of examination the bank was in no imminent danger of great loss."

Page 35: "CBC explained that significant problem loans are presented to the board for proper resolution."

c. Conclusions of Law:

Page 38: Bank is state chartered and subject to FDIC rules and regulations.

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Page 40, N.10: "Respondent often argued that its banking practices did not violate the Manual of Examination Policies (MEP) used by the FDIC as a guide in conducting its examinations.

Other than as stated above, Bank excepts to each and every finding, conclusion, or proposal of the A.L.J.

3. The de minimis character of the alleged unsafe and unsound banking practices is shown by the examiners' and A.L.J.'s criticism of Bank's "Watch List", CBC's Exhibit 40, which lists 149 notes totaling $23,923,000. There were 2 sets of notes which Bank thinks in all fairness should not have been classified substandard, to-wit: (a) W. L. Lockmiller, Lockmiller & Son, Inc., Valley Equipment and Fertilizer Co., Lockmiller & Reid with collateral of $1,644,364.64 securing notes of $873,000, net worth of $3,129,336.36 (Stip. No. 20, 21A, 21B); (b) Calvin Stout, The Blue Room, Inc., Lady J, a division of The Blue Room, Inc., with collateral of $817,525.81 securing notes of $588,780.69, net worth of $1,767,702.38 (Stip. No. 28, 28A, 28B). So 2 notes out of 149 is 1.34% and the total debt of $1,461,780.69 out of a total on the Watch List of $23,923,000 is 6.1%. All this when there is no basis whatsoever for classification in the first instance. No bank can do any better. It cannot in all reason be an unsafe and unsound banking practice to come so close in evaluating a "Watch List" even were Lockmiller and Stout by some stretch of the imagination required to be included therein. There is a total lack of substantial evidence to support any criticism of Bank's "Watch List" or the Lockmiller and Stout entities' loans.

4. The ALJ devotes 4 pages, pages 34 to 38, on the Bank

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Manual of The Citizens Bank of Clovis, FDIC's Exhibit 3 and CBC's Exhibit 56 consisting of 37 sheets setting out Required and Optional Documentation for Loans, and he incorporates such in his Proposed Order to Cease and Desist without pointing to a single instance where anything in that Manual or anything imagined to be left out has contributed to a single loss at Bank. Bank's Supporting Memorandum, pages 87-108, shows that the Manual deals with every requirement of the MEP, p.3.1-1. Bank's Board approves almost all loans and as with most banks, that Board can deviate from any policy as the Board sees fit because the Board manages the daily operation of the bank. There is no evidence that the Bank's Board has failed to conform to the guidelines set forth in MEP, p.3.1-1, as to management, and no changes in management are being required. Between 1966 and 1991 Bank increased its capital accounts from $1,102,800.54 to $17,854,971.58, all from earnings. (CBC's Exhibit 16 and Exhibit 1 thereto). This is an increase of $16,752,171.04. The policies used then are essentially the policies used now. It is arbitrary and capricious for the FDIC to criticize Bank's operations when even the ALJ knows its problems stem from the Curry County Grain & Elevator fraud without Bank's fault and from local economic conditions. (Recommended Decision, p.25; I Ex. 50-52, 57-62, 481). There is a total lack of substantial evidence that Bank's Manual is either inadequate under Bank's circumstances or that anything should be added to it when the Board manages day to day operations.

5. The ALJ tries but fails to justify that 12 C.F.R. Part 323 on Appraisals has been violated by Bank. Bank stands on its statements in its Supporting Memorandum, pages 73-87, which make more sense than the convoluted argument of the ALJ. It is notable that the ALJ did not consider the exceptions to the appraisal requirement if there was such, i.e., the abundance of caution and renewal of credit exceptions.

6. The FDIC feels it has to change something, so it has seized on increasing the number of directors from 3, as required by the State of New Mexico, to 5 for really no stated reason. Bank in its Supporting Memorandum, pages 47-52, has briefed the issue in some depth and attached a summary of the FDIC proposed rule dated May 12, 1993, on outside directors for banks with assets of $500 million. It is absurd, to say the least, to require 2 outside directors when there is no management change to be made. If a cease and desist order is finally approved, no human in his right mind would become a director even if his office could be insured, and Bank does not know of any insurance company that would issue such for a premium that would be affordable by Bank. Strangely, this had never occurred to the Assistant Regional Director. (I Ex. 409, 424-425).

7. The unusual organization of the ALJ's documents leads only to the conclusion that he believes a bank examiner can do anything he or she wants to regardless of regulatory issuances. In this case Bank requested all documents directing examiners what to do. The response was the Memorandum of Examination Policies [MEP], and the ALJ denied Bank's Motion to Compel. (Pleadings). The FDIC did not even produce the Interagency Policies dated March 1, 1991 (CBC's Exhibit 3), the Uniform Agreement on the Classification of Assets and Appraisal of Securities of April 26, 1991 (CBC's Exhibit 3A), the Financial Regulators Issue Joint Supervisory Policy Statement of November 7, 1991, which examiners had notice of for over a year as it states. (CBC's Exhibit 6). The ALJ further denied admission of CBC's Exhibit 4, Treasury News-Easing the Credit Crunch to Promote Economic Growth and CBC's Exhibit 5, Treasury News-The Honorable John E. Robson, Deputy Secretary of the Treasury Before the Committee on Small Business, United States Senate, October 3, 1991, which was before the Report of

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Examination was written and Notice of Charges served. Bank does not believe that the FDIC or any other bank regulatory agency has unfettered discretion to classify assets as a matter of law. The ALJ's reasoning in his "Commentary", p.40 of the Recommended Decision, is not sustainable on any theory. While the FDIC may have considerable discretion to "define" what is an unsafe and unsound banking practice, the FDIC has to give banks notice of such which it has done in the MEP and the other regulatory enunciations. Otherwise, banks are denied due process of law. Bank has briefed this exhaustively in Bank's Supporting Memorandum, p.6 - 47 which is incorporated herein by reference. There is no decided case holding that the FDIC can arbitrarily and capriciously classify a bank's assets contrary to the MEP or the FDIC's regulatory enunciations which bind the FDIC as well as all banks as a matter of law. At the most in the FDIC's favor, the case law states that some deference should be given to the examiner's opinion on classification of assets. Where the experience of Bank's management far exceeds that of the FDIC here as demonstrated by the FDIC's retreat from its high-handed proposals in its first submitted cease and desist order, that deference should not exist as a matter of law. In truth, classification of assets, notes and OREO, require nothing more than what an ordinary businessman values in every day of his business. There is no expertise involved. It is admitted that loans do not have to be collateralized in the first instance. (I Ex. 54, 94-95, 382). But even if collateralized, the examiner's purpose is to determine loss. (I Ex. 85, 378, CBC's Exhibit 6). The Report of Examination, FDIC's Exhibit 2, did not attempt to determine loss in its substandard classifications of assets which were collateralized or the value of OREO supported by complying appraisals. The FDIC's methodology is totally inadequate to accomplish its mission or to be honest and fair with banks. Bank is quite willing to litigate these simple issues which have not been subjected to court review heretofore.

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8. Bank has submitted Bank's Supporting Memorandum and Bank's Reply Brief which is in addition to the detail in the Response of The Citizens Bank of Clovis to Report of Examination as of July 5, 1991, CBC's Exhibit 16. The discussion of the legal and factual issues therein are minutely stated and believed to be accurately presented. Notwithstanding, Bank anticipated having to make written exceptions, accordingly Bank prepared The Citizen Bank's Proposed Findings of Fact and Conclusions of Law in a form useable as exceptions, which with the above Bank's documents Bank does except to the failure of the ALJ to so find and conclude all as follows:

FINDINGS OF FACT

NOTE: "Judge's Exhibit 1, etc. consists of documents titled "CBC's Files" concerning the financial information on each borrower whose loan was classified. These were stipulated into evidence at the outset, (IT6) and stated by Judge Alprin to be called ALJ - 1 etc., but were not labeled as such. "CBC's Files" have typed numbers on the lower right hand corner as "Stip. No. I" "Stip. No. 2", etc. In the testimony these exhibits are referred to as "Judge's Exhibit Number 1", "Judge's Exhibit Number 2" etc., or as "Stipulation 1", "Stipulation 3", etc. These exhibits are listed in a document titled "Stipulation of Facts" entered into by the parties March 3, 1993 and filed in the cause.

Judge's Exhibit No. 2 is a 16 page document titled "Stipulations" entered into by the parties (IT6) mailed for filing in the cause March 9, 1993. This document contains facts and accounting information stipulated by the parties.

The remaining bank exhibits are labeled "CBC's Exhibit 1", "CBC's Exhibit 2", etc. in the lower right hand corner. They are referred to in the testimony as "CBC's l" "CBC's 2", etc.

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The FDIC's exhibits are contained in a loose-leaf notebook. They are referred to in the testimony as "FDIC Exhibit 1", etc. The index sheets in the notebook bears the exhibit number. FDIC's Exhibits 17 and 18 are so numbered.

1. This Court has no jurisdiction because of the willful failure of the FDIC to give the Bank [CBC] a review of the July 5, 1991 Report of Examination by persons not in the supervisory process. (CBC's Exs. 3, 3a, 6, 7). Further, the reviewing person, Calvin B. Riddick, Assistant Regional Director in the FDIC's Regional Office in Dallas, Texas, admits that he did not read all of the Report of Examination and the Bank's policies and therefore it was impossible for him to review it even assuming that he was a proper person to do so. (I Ex. 400, 322, 377, 392, 393, 395).

2. This Court lacks jurisdiction because of the FDIC's erroneous holding that the Bank was not entitled to a private trial thus confining Bank's defenses, so that adverse publicity would be avoided.

3. This Court lacks jurisdiction because of the failure of the presiding Law Judge, Walter J. Alprin, to require the FDIC to answer Bank's Request for Production of Documents which refusal fatally hindered Bank's ability to prepare its case in that substandardization of collateralized loans in toto bears no reasonable relationship to actual or possible losses that might be in the note case.

4. The Bank has more than adequate capital, so the FDIC is not asking for additional capital. (I Ex. 319-322, 428).

5. In fact Bank has a Tier 1 Risk-Based Capital Ratio [Tier 1 Capital to Total Risk Weighted Assets] of 14.11% which is 3.91

times that required on the date of examination. (Stipulations p.4, Par.14(b)). Bank had a Tier 1 Leverage Capital Ratio of 10.30% which is 3.43 times that required at the date of examination. (Stipulations p.3-4, Par.13(a), 13(b); I Ex. 319-322; Attachment only to CBC's Ex. 20; I Ex. 343).

6. The Bank's three (3) directors manage the bank day to day. (I Ex. 325-327).

7. Lynell G. Skarda became a director in Bank in 1959 and became Chairman of the Board in 1968. Langdon L. Skarda became a member of the Board in 1966. Kent Carruthers became a board member in 1986. (I Ex. 434-436).

8. The Citizens Bank of Clovis, N.M. has its main office in Clovis, N.M. with five (5) commercial loan officers, three (3) installment loan officers, one (1) mortgage loan officer, loan officers at branches in Texico and Fort Sumner, N.M., three (3) depository facilities additionally in Clovis, N.M. and having some one hundred (100) to one hundred and six (106) employees over all. (I Ex. 539-541).

9. Kent Carruthers and Lynell G. Skarda attend the morning officers meeting, reviewing new loans, extensions of old loans, overdrafts, and documentation. (I Ex. 541-545).

10. There are no other instructions, directives, memorandums, or regulations to bank examiners other than in the FDIC's Manual of Examination Policies (MEP) and those contained in CBC's Exs. 3, 3a, 6, and 7. (ALJ's Order 5/12/92 and 6/11/92; I Ex. 384, 390-391).

11. That Steven L. Jeffers, the Examiner-in-Charge (EIC) at the July 5, 1991 examination of Bank was approximately twenty-

eight (28) years old on that date, had been a commissioned examiner only one (1) year, had acted as an EIC in only thirteen (13) examinations of banks with assets no larger than $70 million, such being less than one-half the size of The Citizens Bank of Clovis, and by reason of the aforegoing is not qualified to be an expert in this case. (I Ex. 48-51).

12. Kent Carruthers' father was a farmer, so Kent worked his way through the University of Colorado as a mortician and in a financial intern program with the Comptroller of the Currency graduating from college with a Bachelor's Degree in Finance in 1971 joining the Comptroller's Office in January of 1972 as an assistant national bank examiner, becoming a commissioned examiner in May of 1975, leaving that office in 1977 to become V.P. of the First National Bank of Albuquerque which had assets of $700-800 million heading up the loan administration of workout loans becoming later a commercial loan officer. In 1980 Carruthers became Senior Vice-President in charge of lending with the American Bank of Commerce in Albuquerque, N.M. In 1981 Carruthers joined First City Financial Corporation's holding company to complete an application for a new bank in that city which was approved. He then became Executive Vice-President of the same organization then named Moncor when he was transferred to Moncor Bank of Carlsbad, N.A., Carlsbad, N.M. Carruthers joined The Citizens Bank of Clovis, N.M. in March of 1985 as Chief Executive Officer becoming President in early 1986 upon the retirement of T. E. Willmon, Jr. who had been employed by the Bank some forty-five (45) years. As President of the Bank, Kent Carruthers is the chief administrative officer in all facets of the Bank. That by reason of the aforegoing Kent Carruthers is qualified as an "expert" in all aspects of banking participated in by respondent herein. (I Ex. 432-435, 539-545).

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13. The FDIC admits that it erred in demanding in its proposed cease and desist order, FDIC's Exhibit 18, being Par.2, 2(a) thereof, which was attached to its Prehearing Brief, that the Bank amend its written funds management policy because subsequent review of the examination report after management complaints the FDIC determined that there was no problem with this particular area. (I Ex. 336-337). This indicates an arbitrary and capricious conclusion in the Report of Examination, p.1-a-1, under Management Policies that tends to make suspect all conclusions made by the FDIC.

14. The FDIC admits that it erred in demanding in its proposed cease and desist order, FDIC's Exhibit 18, being Par. 2(b) thereof, which was attached to its Prehearing Brief, that the bank adopt procedures to monitor the Bank's liquidity position because a later review showed that the Bank's strategy was acceptable. (I Ex. 336). This indicates an arbitrary and capricious conclusion in the Report of Examination, p.1-a-1, under Liquidity, that tends to make suspect all conclusions made by the FDIC.

15. The FDIC admits that it erred in demanding in its proposed cease and desist order, FDIC's Exhibit 18, being Pars. (h) and (i), and 9 thereof, which was attached to its Pre-hearing Brief, that the Bank shall have and retain qualified management because the evidence shows that no management changes or additional Bank personnel are required. (I Ex. 355-356, 427-428). This makes the FDIC's conclusions as to what is appropriate in a cease and desist order suspect as to the factual basis and necessity therefor.

16. The FDIC admits that it erred in substandardizing the Big Country Ford loans in the amount of $605,000 over Bank's protest and has now passed those loans without qualification. (I Ex. 92-93, 426). An error of this magnitude makes suspect all of the substandard classifications made by the FDIC.

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17. The FDIC admits that between the May 4, 1990 examination and the July 5, 1991 examination that Bank did not make additional loans that were classified substandard or worse, so that there was no deterioration in new loans as implied in the Report of Examination, FDIC's Exhibit 2, p.1, under Overall Condition of the Bank. The FDIC's erroneous conclusion makes suspect all other conclusions in the Report of Examination. (I Ex. 402, 407-409, 418).

18. The Report of Examination of July 5, 1991 is in error in stating in FDIC's Exhibit 2, p.1-a-1, that additional capital is required or should be planned. (I Ex. 319-320, 428). That the proposed cease and desist order, FDIC's Exhibit 18, makes no capital requirements. That this erroneous conclusion in the Report of Examination makes all other conclusions in such suspect.

19. That the Bank Manual of The Citizens Bank of Clovis, FDIC's Exhibit 3 and CBC's Exhibit 56 being the thirty-seven (37) sheets, made a part of and referred to in the Bank Manual setting out Required and Optional Documentation for loans is adequate, so that the Report of Examination, FDIC's Exhibit 2, p. 1-a-1, under Board Supervision and Loan Administration, on loan documentation is erroneous, and there is no basis in the proposed cease and desist order, FDIC's Exhibit 18, Par. (i), (f), for the Bank to make provision outlining the documentation required on all secured loans.

20. That the Bank Manual of The Citizens Bank of Clovis, FDIC Exhibit 3, p.C-31, describes appropriate and adequate collection procedures in detail, so that the Report of Examination, FDIC's Exhibit 2, p.1-a-1, under Board Supervision and Loan Administration is erroneous, and there is no basis in the proposed

cease and desist order, FDIC's Exhibit 18, Par.(g), for the Bank to make provision for collection procedures when borrowers fail to make timely payments.

21. That the Bank Manual of The Citizens Bank of Clovis, FDIC's Exhibit 3 at p.C-7 and p.A-2, adequately cover guidelines for determining what interest rate will be charged on all loans, so that there is no basis in the proposed cease and desist order, FDIC's Exhibit 18, Par.(h), for guidelines for determining what rate of interest will be charged on all secured and unsecured loans.

22. That the Bank Manual of The Citizens Bank of Clovis, FDIC's Exhibit 3, at p.A-4, adequately covers deviation from written loan policies, so that there is no basis in the proposed cease and desist order, FDIC's Exhibit 18, Par.2(a), for a provision providing for deviations from written loan policies requiring approval of the Board of Directors.

23. The admitted fact that the Bank's Board of Directors manages the bank in day to day operations makes unnecessary the provisions for detailed policies in any significant degree greater than the Bank Manual of The Citizens Bank of Clovis, FDIC's Exhibit 3, now provides. (I Ex. 325, 345).

24. The FDIC's Dallas Regional Office accepts as true all facts stated in the Report of Examination prepared by the examiner-in-charge without any supporting papers. (I Ex. 377). There is nothing given to the reviewing office that states the Bank's disagreements with the examiners' conclusions. (I Ex. 374-375)). The EIC was not even shown Bank's Response to the Report of Examination, CBC's Exhibit 16. (I Ex. 73).

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25. Most banks have some violations of law some of which might be significant and others more or less technical. (I Ex. 424). Bank here was no different in this respect than most banks.

26. There is no requirement that collateral constantly or continually be inspected. (I Ex. 91-95, 168, 417). Bank's borrowers were old and seasoned customers, and no loss is evidenced by failure to constantly inspect collateral. (I Ex. 93-95, 168).

27. There is no requirement by the FDIC that loans be collateralized. (I Ex. 54, 94-95, 382).

28. The purpose of a bank examination is to determine risk of loss. (I Ex. 85, 378, CBC's Ex.6). Loss was not determined nor effort made to determine actual loss in Bank's assets in the July 5, 1991, examination, because loss cannot be determined by substandard classification without valuation of the collateral securing the loan. The Report of Examination shows that this is what was done in FDIC's Exhibit 2.

29. The EIC in the July 5, 1991 examination admits that he and the FDIC do not commonly apply the MEP, p.3.1-23, definition of a substandard loan in their classifications. (I Ex. 52-53, 83).

30. The EIC admits that borrowers do not have to be in a position to liquidate their loans at all times as stated in MEP, p.3.1-22. (I Ex. 86-89). This was not applied to Bank's debtors.

31. The fact that the new Interagency Policy directives, CBC's Exhibits 3, 3a, 6, were known to the EIC and FDIC they were not applied to the July 5, 1991 examination on the theory that in some mysterious way they were being applied before they were published. (I Ex. 61-63, 79, 82, 397-400).

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32. The EIC and the FDIC erroneously refuse to apply the designation of "Special Mention" to all of Bank's notes and OREO despite the provisions of MEP, p.3.1-22, 3.1-23. (I Ex. 96-99, 360-361). That all of Bank's loans and OREO at the worst should have been classified "Special Mention" rather than "Substandard" except as to those classified "Probable" or "Loss".

33. The EIC and the FDIC erroneously refuse to apply the designation of Split Classification to all assets despite the clear provisions of MEP, p.3.1-23. That all of Bank's loans and OREO classified Substandard were either collateralized or had substantial value which was ignored by the examiners resulting in a distorted conclusion as to the classification and value of Bank's assets. (I Ex. 95-99, 361-362, 386-387).

34. An asset, loan or OREO, collateralized or with an appraised value, requires only the application of simple addition, i.e., bean counting, to determine whether such should be classified under the MEP making unnecessary the exercise of any judgment by the bank examiner. Bank properly capitalized interest here.

35. The FDIC theory that it is improper for Bank to capitalize interest is not a prohibited act stated in the MEP. (I Ex. 176-182). In fact, if either the loan and capitalized interest is collateralized or the paying capacity of the borrower is adequate, capitalization of interest cannot in fairness be criticized. (I Ex. 180-183, 203-204).

36. Bank had substantial factual bases for the capitalization of interest in each instance in which it was done.

37. Other real estate owned [OREO] is basically no different than a mortgage held by Bank on realty. (I Ex. 59, 98-101). In fact the Bank can legally hold other real estate. (I Ex. 40).

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38. There is no directive that requires a bank to have what is called a Watch List or to grade loans on such. Bank had a good Watch List. (I Ex. 140, 141, CBC's Ex. 51).

39. There is no written law or regulation that requires Bank to have written policies. (I Ex. 120, 123, 133-134).

40. The Bank Manual of The Citizens Bank of Clovis is adequate considering a bank of its size and circumstances. (FDIC's Exhibit 3, CBC's Exhibit 56).

41. Personal statements (P.S.) prepared by income tax accountants do not reflect the market value of the borrower's assets, but rather use the depreciated value under the Internal Revenue Service regulations. (I Ex. 84, 228).

42. Carryover agricultural debt does not require that such be classified substandard if the borrower has sufficient assets. (I Ex. 183-189).

43. There is no evidence that Bank's management here has failed to conform to the guidelines set forth in the MEP, p.4.1-10, for bank management. (I Ex. 208, 311-312).

44. There is no requirement in the MEP that the Bank have a repayment plan for notes due on demand. (I Ex. 172-175, 412-413).

45. There is no requirement in the MEP or elsewhere that notes payable to the Bank be held under dual control. (I Ex. 213-214).

46. The general ledger titles did not cause results that made the examination difficult. (I Ex. 214-215).

47. There is nothing that requires Bank's Board of Directors to put in its minutes information concerning additions to its property and equipment. (I Ex. 215-216).

48. Only two (2) loans, those of Calvin Stout and W. L. Lockmiller or Lockmiller & Son, were not on Bank's "Watch List", and both were fully collateralized and were misclassified by the examiners. (I Ex. 164, 169, 172, 182, 217-223, 254-260, 301-304, 470-481, 537-538).

49. The Bank Manual of The Citizens Bank of Clovis adequately provides for collection policies for borrowers who do not pay. (I Ex. 198-200, FDIC's Exhibit 3, p.C-31).

50. The "Allowance for Loan and Lease Losses" [ALLL] even if deficient, Bank has adequate capital, so ALLL is really immaterial in determining the safety and soundness of the Bank here. (I Ex. 111-113, 210-211, 423-424, 428-429).

51. The fact that Bank had some $4 - 5 million in non-earning assets frozen or tied up as a result of the Garrett relationship litigation is not something for which Bank can be blamed or criticized. (I Ex. 420-421).

52. Bank's officers were forthright in trying to answer any questions put to them by the examiners. (I Ex. 91).

53. In Curry County, New Mexico dryland farmers make a wheat crop about six (6) out of every ten (10) years and a milo crop about four (4) out of every ten (10) years. (I Ex. 41-42, 481).

54. The July 5, 1991 Report of Examination misstates the value of A & M Building Systems, Inc. at $1,633M when the parties in

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Stipulation No. 1 agreed that the value was significantly larger being $2,681.4M, a difference of $1,048.4M or 64.2%. The collateral value was more than ample to secure a debt of $1,626M, regardless of low profits, so it was error to classify the asset as substandard. (FDIC Exhibit 2, p.2-a, 2-a-1; Stip. No. 1).

55. The July 5, 1991 Report of Examination misstates the value of A & M Farm and Ranch Supply, Inc. at $1,218M when the parties in Stipulation No. 2 agreed that the value was significantly larger being $2,200.282M assuming accumulated depreciation of $543.169M reflects actual market value, a difference of $982.282M or 80.64%. The collateral value was more than ample to secure a debt of $972M, regardless of minimal losses, so it was error to classify the asset as substandard. (FDIC Exhibit 2, p.2-a, 2-a-1; Stip. No.2).

56. On April 29, 1966 Bank had Total Capital Accounts of $1,102,800.54 with Total Assets of $17,588,818.99. (CBC's Exhibit 16 and Exhibit 1 thereto). On July 5, 1991 CBC had Total Equity Capital of $17,854,971.58 with Total Assets of $161,754,611.28. (FDIC Exhibit 2, Officer's Statement of Assets and Liabilities). This is an increase of $16,752,171.04 in Total Equity Capital and an increase of $144,165,792.29 as a result of Bank's management during the last twenty-five (25) years. As a result the conclusion has to be that Bank's management is competent in all respects.

57. There is no factual basis for increasing the number of board members from three (3) to five (5). (I Ex. 424-425, 409-410).

58. The economy in the Clovis, N.M. area was depressed or not good in the period preceding the July 5, 1991 bank examination. (I Ex. 50-52, 57-62, 481).

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59. The Curry County Grain & Elevator Co., Inc. properties [elevators] were acquired through the consent of Bank's primary regulator, the Director of Financial Institutions of the State of New Mexico, as being the proper thing to do under the unusual circumstances. (I Ex. 437-435, CBC's Exhibit 21,22,23,24).

60. Bank was authorized by its primary regulator, the New Mexico Director of Financial Institutions, to operate or otherwise lease the elevators and to retain ownership for a period of more than five (5) years or such time as the Director might allow. (CBC's Exhibits 25, 26).

61. The elevators are an earning asset of Bank being an investment yielding more income over time than a similar investment in U.S. Treasuries. (CBC's Exhibit 35, 35b).

62. Bank has had the elevators appraised every year by a certified State appraiser, and the elevators' value is properly carried on Bank's books at $8,400,000, the appraisal value. (CBC's Exhibits 31, 32, 33).

63. The elevators were classified in this examination when they made more money than in the 1990 examination, so they should not have been classified substandard, but at the worst should have only been placed in Special Mention. (I Ex. 439-446, FDIC's Exhibits 1, 2; CBC's Exhibit 35).

64. New Mexico did not have State licensed or certified appraisers until May of 1991. (I Ex. 493-494). It was impossible for banks in New Mexico to comply with 12 C.F.R. Part 323 assuming that such was in force and effect at the time of the July 5, 1991 examination.

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65. The objective and verifiable facts on substandard classifications appear in the Exhibits marked Stip. No. 1 through Stip. No. 35 and bear more weight than oral statements and are accurate as to the collateral values as so stipulated. (I Ex. 397-398). As a result the classifications, if any, should be either Passed, i.e., not classified or at the worst classified Special Mention, as shown by the cited evidence as there is no preponderance of the evidence proving that there is a foreseeable risk of loss greater than normally expected in bank loans which are all expected to have some risk of loss, so that the examiners' substandard classifications exceed the "zone of reasonableness" permitted in any assumed discretion available to the examiners or is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law, as follows:

[Cents are Eliminated]

STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
1.	A & M Bldg. Sys.	$2,681,400	$1,626,000	($ 604,897)
	Substandardized $1,626,000			
	Should be passed or special mentioned			
	Nels E. Anderson, Guarantor (Stip 3, IV Ex. 1941)			$2,098,782
	(Stip.No.1, IV Ex. 1929; I Ex. 223, 226-229, 390, 405, 446-448, 453-456, 530, 374, 377-380).			
2.	A & M Stores	$2,200,282	$ 972,000	$ 364,086
	Substandardized $837,000			
	Should be passed or special mentioned			
	Nels E. Anderson, Guarantor (Stip 3, IV Ex. 1941).			$2,098,782
	(Stip.No.2, IV Ex. 1936; I Ex. 226-229, 405, 446-448, 453-455, 528-529, 374, 456-457).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
3.	Barth	$45,000	$41,007	$5,795
	Substandardized $41,000			
	Should be passed or special mentioned (Stip.No.4; IV Ex. 1942; I Ex. 231-236, 457-458).			
4.	B&B Auto (Calder)	$294,250	$297,961	$604,056
	Substandardized $277,000			
	Should be passed or special mentioned (Stip.No.5, IV Ex. 1943; I Ex. 235, 299, 458-459).			
5.	Blythe	$183,750	$85,703	$65,343
	Substandardized $86,000			
	Should be passed (Stip.No.6, IV Ex. 1947; I Ex. 236-237, 460).			
6.	Crispin	$7,400	$2,950	0
	Substandardized $3,000			
	Should be passed (Stip.No.7, IV Ex. 1948; I Ex. 236, 461).			
7.	Clovis Sheetmetal	$55,500	$43,135	$63,000
	Substandardized $43,000			
	Should be passed (Stip.No.8, IV Ex. 1949; I Ex. 237, 461-462, 533-534).			
8.	L. Eaton	$231,200	$105,394	$173,703
	Eaton Well	same	$81,562	same
	Substandardized $187,000			
	Should be passed (Stip.Nos. 9,10, IV Ex. 1950-1951, I Ex. 237-238, 462).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
9.	Ellis	$ 128,000	$ 38,848	$ 87,980
	Substandardized $39,000			
	Should be passed			
	(Stip.No.11, IV Ex. 1952; I Ex. 238-239, 462, 534-535).			
10.	Elliott	$ 745,126	$ 731,911	$ 187,902
	Substandardized $ 732,000			
	Should be passed or special mentioned			
	(Stip.No.12, IV Ex. 1953; I Ex. 239-240, 463-464).			
11.	D'Aun Garrett	$ 411,000	$ 377,786	$ 322,797
	Substandardized $ 300,000			
	Should be passed or special mentioned			
	(Stip.No.13, IV Ex. 1954; I Ex. 240, 464-466).			
12.	Malc. Garrett	$2,009,528	$2,081,688	$1,744,781
	(Stip.No.14, IV Ex. 1955; I Ex. 199, 207, 242-243, 466-468, 524-525).			
	Garrett Corp.	$1,123,342	$1,507,545	$ (391,561)
	(Stip.No.15, IV Ex. 1958; I Ex. 199, 206, 207, 243-244, 468, 506).			
	Garrett Estates	$2,488,680	$1,634,580	$1,053,311
	Garrett Farms			
	(Stip.No.15A, IV Ex. 1960; I Ex. 350, 354-355, 467-468).			
	All above substandardized $4,838,000 and loss $335,000			
	Should have special mentioned $4,838,000 and loss explained.			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
13.	Hager Sign Co.	$339,029	$334,325	($362,833)
	Substandardized $334,000			
	Should be passed or special mention (Stip.No.16, IV Ex. 1962; I Ex. 244, 469, 536).			
14.	Hamilton Nursery	$238,622	$125,452	($25,687)
	Substandardized $125,000			
	Should have passed or special mentioned (Stip.No.16A, IV Ex. 1964; I Ex. 246-247, 406, 474-475).			
15.	Hardisty	$603,756	$487,822	$170,815
	Substandardized $455,000			
	Should have passed or special mentioned (Stip.No.16B, IV Ex. 1965; I Ex. 247-248, 404, 475).			
16.	S.Harrell	$197,050	$191,094	$167,974
	Harrell Co.			
	Substandardized:			
	S.Harrell:	$104,000		
	Harrell Co:	$87,000		
		$191,000		
	Should have passed or special mentioned (Stip.Nos. 17,17A, IV Ex. 1967, I Ex. 248-249, 475-476).			
17.	Huggins	$70,875	$42,117	$103,000
	Substandardized $41,000			
	Should have passed (Stip.No.18, IV Ex. 1969; I Ex. 250-252, 476-477).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
18.	W. Johnson	$952,465	$333,501	$1,593,574
	Substandardized $332,000			
	Should have passed			
	(Stip.No.18A, IV Ex. 1970; I Ex. 252-254, 477-478).			
19.	E. Lingnau	$77,940	$63,479	$ —
	Alma Lingnau, Guarantor			$322,500
	Substandardized $61,000			
	Should have passed			
	(Stip.No.19, IV Ex. 1972; I Ex. 254, 478).			
20.	Lockmiller & Son	$1,554,364	$873,000	$3,570,919
	Valley Equipment	$100,000	$127,000	—
	W. L. Lockmiller, Guarantor			$3,129,336
	G. L. Lockmiller Guarantor			$4,023,482
	Dennis Reid Guarantor			$221,778
	Substandardized $588,000			
	Should have passed			
	(Stip.Nos.20,21A,21B, IV Ex. 1973-1975; I Ex. 169-172, 182, 219, 223, 254-260, 301-304, 479-481, 537-538).			
21.	Mobile Serv. Center	$88,900	$40,585	$157,943
	Substandardized $40,000			
	Should be passed			
	(Stip.No.22, IV Ex. 1976; I Ex. 260, 482).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
22.	Pattison	$295,500	$672,516	$605,000
	Substandardized $385,000 Loss $163,000			
	Should have passed or special mentioned (Stip.No.23, IV Ex. 1977; I Ex. 169, 203-205, 380-381, 482, 525).			
23.	R&M Truck	$356,400	$372,114	$239,385
	Connell, Alan			$43,946
	Connell, Roy			$279,000
	Substandardized $372,000			
	Should have passed or special mentioned (Stip.24, IV Ex. 1978; I Ex. 261, 482-483).			
24.	Reichert	$1,400,000	$1,261,429	$256,113
	Substandardized $1,210,000			
	Should have passed or special mentioned (Stip.No.25, IV Ex.1980; I Ex.261-262,483-484).			
25.	Eldridge, Dean	$250,000	$281,331	($242,912)
	Substandardized $256,000 and loss $25,000			
	Should have passed or split classification (Stip.No.26B, IV Ex. 1984; I Ex. 177, 189, 203-204, 406, 484-485).			
26.	Eldridge Companies	$93,333	$167,496	$76,718
	Dean Eldridge Guarantor			
	Substandardized $168,000			
	Should have split classification (Stip.No.26A, IV Ex.1983; I Ex.189,406,484-485).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
27.	Rochelle Corp.	$1,772,000	$1,389,670	$279,560
	Dean Eldridge Guarantor			
	Substandardized $1,389,000			
	Should have passed or special mentioned (Stip.No.26, IV Ex. 1981; I Ex. 177, 189, 203-204, 406, 485).			
28.	Scott	$138,280	$104,176	$101,484
	Substandardized $106,000			
	Should have passed (Stip.No.27, IV Ex.1985; I Ex.262-263,485-486).			
29.	Stout, C.	$659,000	$303,400	$1,574,113
	Substandardized $303,000			
	Should have passed (Stip.No.28, IV Ex. 1986; I Ex. 219, 263-266, 299-301, 486-487).			
	Blue Room	$103,231	$73,670	$65,714
	Stout, C., Davis, Gardner, Guarantors			
	Substandardized $73,000			
	Should have passed (Stip.No.28A, IV Ex.1988; I Ex.264-266,486-487.			
	Lady J.	$55,290	$211,710	($193,589)
	Stout, C., Davis, Gardner, Guarantors			
	Substandardized $204,000			
	Should have passed (Stip.No.28B, IV Ex.1989; I Ex.263-266,486-487).			
	Total Debt all 3 entities =		$588,780	
	Total Collateral all 3 entities =		$817,521	

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
30.	Sudderth	$ 52,800	$ 30,152	$ 8,300
	Guarantor Glenden Sudderth			$ 299,670
	Substandardized $ 30,000			
	Should have passed			
	(Stip.No.29, IV Ex.1990; I Ex.266,487-488).			
31.	Sumrall, Don	$ 84,450	$ 76,935	$ 4,845
	Substandardized $75,000			
	Should have passed			
	(Stip.No.30, IV Ex. 1991; I Ex. 266,488).			
32.	Tapia	$ 23,000	$ 29,952	$ 84,200
	Substandardized $ 30,000			
	Should have passed			
	(Stip.No.31, IV Ex.1992; I Ex.267-268,488-489).			
33.	Wall	$ 139,000	$ 86,224	$ 475,555
	Substandardized $80,000			
	Should have passed			
	(Stip.No.32, IV Ex. 1993; I Ex. 268-269, 406, 489-490, 522).			
34.	Westside Sheetmetal Allison, Guarantors	$ 725,633	$ 784,675	$ 297,951
	Substandardized $685,000 and $100,000 loss			
	Should have passed or special mentioned			
	(Stip.No.33, IV Ex. 1994; I Ex. 490-491).			

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STIP. NO.	BORROWER	COLLATERAL	DEBT	P.S.
35.	Wood, John	$351,694	$120,234	$321,594
	Substandardized $120,000			
	Should have passed			
	(Stip.No.34, IV Ex. 1996; I Ex. 269-271, 304, 491-492).			
36.	Woody's	$53,339	$46,000	N/A
	Substandardized $46,000			
	Should have passed or special mentioned			
	(Stip.No.35, IV Ex.1998; I Ex.127,492).			

66. The objective and verifiable facts on "Other Real Estate Owned" [OREO] classifications appear in the exhibits marked CBC's Exhibits 31-33, 55a. through and including 55m., such being the appraisals thereon, and no evidence or appraisals have been offered by the FDIC to controvert said CBC's Exhibits so numbered. As a result the classifications of OREO should be as follows:

PROPERTY NAME	APPRAISAL	VALUE
1. Elevators	2/23/87,CBC's Ex.31, II Ex. 873	$10,004.644
	1/9/89,CBC's Ex.32, III Ex. 1236	$10,004,644
	2/13/90,CBC's Ex.32A, III Ex. 1245 without excess land	$9,500,000
	3/31/91,CBC's Ex.33, III Ex. 1261	$ 8,400,000
	Should be passed.	
	(I Ex. 271-281, 403-409, 501-503, 516-519, 522, 539).	

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2.	Black	6/19/89,Rep.of Exam, p.2-a-23, IV Ex. 2335, 2001	$95,000
		12/6/90,same	$36,000
	Should be passed. (I Ex. 283-286, 494-495).		
3.	Bucksath	8/8/90,CBC's Ex.55b, IV Ex. 2002	$ 40,100
	Should be passed. (I Ex. 286-287, 495-496).		
4.	Bunce	2/12/91,CBC's Ex.55c, IV Ex. 2003	$160,000
	Should be passed. (I Ex. 288, 496-497).		
5.	Chapparal	5/24/91,CBC's Ex.55d, IV Ex. 2028	$182,300
	Should be passed. (I Ex. 497-498).		
6.	Crow	5/2/91,CBC's Ex.55e, IV Ex. 2046	$300,000
	Should be special mentioned as acquired 6/20/91. (I Ex. 498-499).		
7.	Gartner	3/25/91,CBC's Ex.g, IV Ex. 2053	$61,700
	Should be passed. (I Ex. 499).		
8.	Horton	7/10/91,CBC's Ex.h, IV Ex. 2070	$60,900
	Should be passed. (I Ex. 499).		
9.	Jordan	12/20/90,CBC's Ex.i, IV Ex. 2078	$92,000
	Should be passed. (I Ex. 500).		

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10. Lucero	12/31/90,CBC's Ex.55j, IV Ex. 2080	$ 102,000
Should be passed. (I Ex. 500).		
11. Neuser	2/28/91,CBC's Ex.55k, IV Ex. 2104	$ 86,000
12. Velez	9/29/89,CBC's Ex.551, IV Ex. 2120	$ 135,000
13. Vohs	2/25/91,CBC's Ex.55m, IV Ex. 2122	$ 115,000

67. Every substandard classification of OREO recites that such is the result of "an adverse real estate market", or "no firm prospects for disposition" or similar verbiage, all of which is directly contrary to the Joint or Interagency Policies announced March 1, 1991, CBC's Exhibit 3, that announced April 26, 1991, CBC's Exhibit 3A, and that announced November 6, 1991, CBC's Exhibit 6, which is conclusive proof that the examiners have not been applying the above policies contrary to their testimony in this case.

68. The examiners have substandardized the full amount of collateralized loans and the full appraised value of OREO despite the fact that they admit that they are supposed to value each loan and OREO property, but which they have wholly failed to do. The classifications of substandard loans and OREO are therefore not supported by substantial evidence. (I Ex. 83-84, 88-89, 97, 378).

69. The land owned by D'Aun Garrett was never out of compliance in the Conservation Reserve Program [CRP], so that was not a ground for substandardizing her loan in the bankruptcy proceeding. (I Ex. 466).

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70. The New Mexico Cooperative Extension Service projected crop costs for Curry County, New Mexico, make it unnecessary for farmers to make projections for Bank's collateral files. (CBC's Exhibits 37, 38, 39).

71. That Bank charged off a portion of loans, keeping that portion which was secured in Bank's note case, does not afford a basis for classifying substandard those notes so retained.

72. The FDIC has failed to prove by a preponderance of the evidence that Bank's management was not prudent under all the circumstances of this case, most of which facts are admitted or stipulated as set out above.

CONCLUSIONS OF LAW

1. This Court lacks jurisdiction because of the willful failure of the FDIC to give the Bank a review of the July 5, 1991 Report of Examination in accordance with the policies or directives enunciated in the March 1, 1991 "Regulators Issue Joint Supervisory Policies [CBC's Ex. 3], the April 26, 1991 "Uniform Agreement On the Classification of Assets and Appraisal of Securities" [CBC's Ex. 3A], the November 7, 1991 "Financial Regulators Issue Joint Supervisory Policy statement" [CBC's Ex. 6], and the February 7, 1992 "Procedures for Requesting Review of Supervisory Decisions by FDIC" which delineated what all knew would be necessary to afford a bank an impartial review. Had Bank been given a proper review as obviously contemplated by said Exhibits, this cause would not have been filed. The significant factual and administrative error determinations which would have been found on a review together with the expenditure of time and money on this matter indicates the merit in labeling a proper review when requested as a condition precedent to filing notice of charges.

2. This Court has no jurisdiction because the FDIC arbitrarily ruled that there should be a public trial, in which in this case necessitated the sealing almost all of the record to keep from injuring those borrowers. Under these circumstances Bank is self-restricted in its defenses to protect its borrowers from adverse publicity resulting in a lack of due process to Bank.

3. This Court has no jurisdiction because the denial of Bank's Request for Production fatally hindered Bank's ability to prepare its case in that substandardization of collateralized loans in toto bears no reasonable relationship to actual or possible losses that might be in the note case.

4. The FDIC under 5 U.S.C.S. §556(d) has the burden of proof on the charges made against Bank requiring proof of such charges by a preponderance of the evidence which is to say that there is no presumption of correctness in the FDIC's determination nor any discretionary binding power as the FDIC is not excepted under 5 U.S.C.A. §701(a). This is to say that there has to be substantial evidence to support every allegation of the charges which means more than an allegation. Even more so is this applicable when the Bank presents evidence by its President who is an expert of more actual experience than that presented by the FDIC.

5. The FDIC's Manual of Examination Policies [MEP], CBC's Exhibit 15, as it existed on July 5, 1991, the date of the Report of Examination, is substantive or legislative law which both the Bank and the FDIC must follow and be bound.

6. Equally, the Interagency Polices appearing as CBC's Exhibits 3, 3a, 6, and 7 are substantive or legislative law which both the Bank and the FDIC must follow and be bound.

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7. The use of the disjunctive word "or" in MEP, p.3.1-23, as clarified in the Interagency Policies in CBC's Exhibits 3, 3a, 6, and 7 were announced October 8, 1991, so that MEP, p.3.1-23, in explicit English means as follows:

> "Loans adequately protected by either the current sound worth and paying capacity of the obligor, guarantor or of the underlying collateral, if any, generally are not classified. Loans classified substandard must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected."

The last two (2) sentences above apply generally only to evaluating "current sound worth and paying capacity" of borrowers or guarantors with unsecured loans. Collateralized loans are either secured or not secured, so "weakness or weaknesses" or "deficiencies" are not terms affecting collateral. This is borne out in the November 7, 1991 statement at p.6 where it is stated:

> "As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified."

8. The FDIC has admitted that bank letters, policy statements, and other regulatory issuances . . . are to be followed. Insured

institutions are not free to disregard FDIC issuances. . . ." in *The Citizens State Bank of Cortez, Cortez, Colorado, Docket No. FDIC-89-220b (6-11-91) reported at ¶5166, p.A1734.17, at p.A-1739.* Such regulatory issuances must be followed both by Bank and the FDIC. The FDIC admittedly has disregarded its own case law in the examination of Bank.

9. There is no regulatory issuance by the FDIC that prohibits the capitalization of interest nor is there anything in the MEP that forbids such. The FDIC in this case has classified all capitalization of interest regardless of the circumstances.

10. Neither the MEP nor any regulatory issuance requires that Bank's loans be collateralized.

11. The MEP recognizes that all loans "involve some risk", but that "does not mean that borrowers must at all times be in a position to liquidate their loans, for that would defeat the original purpose of extending credit." MEP, p.3.1-22. The FDIC admits that it has not applied this regulatory issuance in the examination of Bank as it has only considered immediate full payment of loans being had.

12. Deference to the examiners' classification of loans and OREO is not applicable here as the examiners have failed to follow the FDIC's regulatory issuances which are outside the "zone of reasonableness" in any event, making those classifications arbitrary, capricious, and abusive of discretion. *Sunshine State Bank v. FDIC. 783 F.2d 1580 (Cir. 11, 1986).*

13. Grading of loans in a "Watch List" is not required by any regulatory issuance. CBC's Exhibits 51 and 50.

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14. Bank here being well-capitalized could have practices in banking that a lesser capitalized bank could not do which the examiners failed to consider. *First National Bank of Eden v. Dept. of Treasury. 568 F.2d 610 (Cir. 8, 1978).*

15. Neither the MEP nor any regulatory issuance requires Bank to constantly inspect collateral of its long-time and seasoned borrowers nor is documentation required for inspections.

16. Neither the MEP nor any regulatory issuance requires Bank to decline to loan to a borrower whose loan has been classified substandard.

17. Guaranties are the equivalent of collateral under MEP, p.3.1-36, and the Joint or Interagency Policies announced March 1, 1991, CBC's Exhibit 3, that announced April 26, 1991, CBC's Exhibit 3A, and that announced November 6, 1991, CBC's Exhibit 6, all of which are applicable to Bank's examination.

18. Neither the MEP nor any regulatory issuance requires that Bank have a repayment policy any different from that stated maturity in its notes as such prevents a lender's liability suit.

19. The FDIC's main function in the examination of Bank was to determine loss, if any, which the FDIC failed to do by classifying collateralized or guaranteed loans and OREO as substandard in toto as if they were unsecured by ignoring the value of the collateral, guaranty and OREO, and treating such if no value existed, which is meaningless and contrary to the direction of the MEP and the regulatory issuances contained in CBC's Exhibits 3, 3a, and 6.

20. The MEP, p.3.1-29, specifically provides for the splitting of

classifications in substandard loans, but which in Bank's examination was used only in the case of Lockmiller, which failure to use adversely distorted the condition of Bank and is unfair to the borrowers and Bank.

21. The MEP, p.3.5-1, similarly requires that OREO be classified on each property's own merits as such is an asset under the April 26, 1991 regulatory issuance, CBC's Exhibit 3A, so to classify valuable OREO as all substandard distorts the condition of Bank.

22. This distortion appears most clearly in the classification of the elevator properties which are very substantial income producing assets as being substandard in the amount of $8,400,000, their appraised value.

23. The MEP, p.3.1-22 and 3.1-23, provide for Special Mention for assets which do not presently expose the bank to sufficient risk to warrant adverse classification. Notes and assets in litigation such as the Malcolm G. Garrett 14,320 acre ranch with a decision for Summary Judgment in Bank's favor, CBC's Exhibits 27, 28, and 29, Garrett Corporation's 2,720 acre farm in litigation, CBC's Exhibit 53, and D'Aun Garrett's bankruptcy with Bank having a secured claim on a 1,600 acre farm, CBC's Exhibit 52, are examples of assets which more appropriately could be classified Special Mention" as their respective histories prove.

24. The ownership by Bank of OREO is legal under §58-1-2SA, NMSA 1978, CBC's Exhibit 25, and can legally be held as long as the New Mexico Director of Financial Institutions determines, CBC's Exhibit 26.

25. The ownership of the elevators, such now being OREO in the

amount of $8,400,000, was acquired with the consent of the New Mexico Director of Financial Institutions, which acquisition is not subject to classification as substandard by the FDIC when supported by a proper appraisal as the New Mexico official exercises sole jurisdiction over State chartered banks in this regard. CBC's Exhibits 21, 22, 23, and 24.

26. Under New Mexico law and the regulatory issuances, CBC's Exhibits 3, 3A, and 6, Bank did not have to dispose of its OREO at a fire sale price, so it was arbitrary, capricious, an abuse of discretion and contrary to law for the FDIC to classify Bank's OREO as all substandard contrary to existing appraisals.

27. The FDIC regulation, 12 C.F.R. Part 323, on State and licensed appraisers recites that it was issued under 12 U.S.C. §3331 et seq. of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 [FIRREA], to be effective September 19, 1991. The Appraisal Subcommittee appointed under FIRREA on May 1, 1991, which was before the Bank's July 5, 1991 examination, the State appraiser requirements were extended to December 31, 1991. On July 11, 1991 the Federal Financial Institutions Examination Council [FFIEC] extended the State appraiser requirements to January 1, 1992. The FDIC Improvement Act of 1991 amended FIRREA, 12 U.S.C. §3348(a)(1), by extending the effective date to December 31, 1992. On March 16, 1992 the FDIC in 12 C.F.R. §323.3(d) extended the effective date for use of State certified and licensed appraisers to December 31, 1992. It is well settled that for regulations, here 12 C.F.R. Part 323, to be valid they must be consistent with the statute under which they are promulgated. The aforegoing extension dates made 12 C.F.R. Part 323 inconsistent with FIRREA under which it was promulgated. Consequently, Bank on July 5, 1991 could not have violated an invalid 12 C.F.R.

Part 323 even if New Mexico had State certified and licensed appraisers.

28. FIRREA in 12 U.S.C. §3349 prohibited Bank from using other than a State certified or licensed appraiser unless Bank wished to incur civil money penalties. Thus, Bank could not be required to do something it was by FIRREA forbidden to do.

29. There was no regulatory issuance of any kind that required Bank to have appraisals of real property on July 5, 1991.

30. Equally, there was no regulatory issuance of any kind that required Bank to have appraisals of personal property collateral on July 5, 1991.

31. Neither the MEP nor any regulatory issuance requires Bank to have written policies.

32. The Bank Manual of The Citizens Bank of Clovis is adequate considering a bank of its size and circumstances where the Board of Directors actually manages the bank.

33. Neither the MEP nor any regulatory issuance including FDIC's Exhibit 16, such being a Comptroller Memorandum, requires that carryover agricultural debt be classified substandard where the borrower has sufficient assets or collateral.

34. Neither the MEP nor any regulatory issuance requires that notes owned by Bank be under dual control.

35. Neither the MEP nor any regulatory issuance requires that Bank put in its minutes information concerning additions to its

property and equipment. Such can be determined more easily by looking at Bank's depreciation sheet or its general ledger.

36. Even if Bank's Allowance for Loan and Lease Losses [ALLL] is deficient, such is immaterial in determining the safety and soundness of Bank where, as here, Bank has significantly more capital than is required.

37. That Bank has some $4 - 5 million in non-earning assets frozen or tied up as a result of the Garrett litigation and has had to spend some $1 million on attorney fees which decreased Bank's earnings severely, are not results for which Bank's management can be blamed or criticized as a matter of law.

38. Neither the MEP nor any regulatory issuance states or implies that earning assets held by Bank in OREO have to yield as much as Bank's loans to keep that asset from being classified substandard.

39. OREO should be classified as an investment rather than as a loan as a matter of law.

40. The fact that the State of New Mexico did not have State certified or licensed appraisers available, negatives any finding of violations of 12 C.F.R. Part 323 by Bank.

41. This Court concurs in Bank's conclusion that the loans summarized in Par. 65 of Bank's requested Findings of Fact should not have been classified substandard, but at the worst should have been classified Special Mention as they were substantially collateralized or the borrower had the capacity to pay and sound net worth all as objective and verifiable facts.

42. This Court concurs in Bank's conclusion that the OREO

summarized in Par. 66 of Bank's requested Findings of Fact should not have been classified substandard, but at the worst should have been classified Special Mention as they were supported by adequate appraisals such as required at that time, all of which are objective and verifiable facts to which the FDIC has not offered evidence to controvert.

43. The FDIC has admitted that contrary to the charges the Bank did not deteriorate its assets by making further bad loans between the May 4, 1990 examination and the July 5, 1991 examination, so Bank did not violate its Resolution as alleged.

44. MEP p.4.1-10 and 11 clearly require that examiners give appropriate recognition to external problems such as a depressed local economy which is admitted as such here and to which should be added the huge burden on Bank in the Garrett litigation and its resultant expense, neither of which have been given the weight by the examiners that this Court thinks they merit because a lack of such consideration distorts the condition of Bank and reflects unjustifiably adversely on management.

45. Neither the MEP nor any regulatory issuance requires that loans be reduced when such are adequately collateralized or the borrower has the capacity to pay and sound worth.

46. If all classifications are a judgment call as stated by Calvin B. Riddick, 4 T 88-89, as to the examiners, then it is equally a judgment call as to Bank's management in determining the names in Bank's Watch List and the amount to be put in the ALLL.

47. If one assumes that 12 C.F.R. Part 323 was in force and effect on July 5, 1991, exclusions from that part are found in §323.4(2) as to liens taken through an abundance of caution, and in

§323.4(4) as to renewals of loans entered into before the regulation's effective date.

48. There is no legal basis for asking for an increase in the Bank's number of directors when §58-1-65, NMSA 1978, requires only three (3) and there is no preemption provision in the FDIC Act nor even in the FDIC Improvement Act of 1991 the independent audit committee requirements of which were ruled on the week of May 3, 1993 as being applicable only to bank's with assets of $500 million or more.

49. The extensive evidence and law presented in this case should be reviewed bearing in mind that the future will be affected by the FDIC Improvement Act, signed December 19, 1991, where in 12 U.S.C. §1828(o)(3) it provides:

> "(3) Loan Evaluation Standard. - No appropriate Federal banking agency shall adversely evaluate an investment or a loan made by an insured depository institution, or consider such loan to be nonperforming, solely because the loan is made to or the investment is in commercial, residential, or industrial property, unless such investment or loan may affect the institution's safety and soundness.

This statute would seem to negative what appears to be a disposition by the regulatory agencies to look with jaundiced eye at anything involving real estate.

50. Bank's actions taken in good faith based on regulatory issuances of the FDIC cannot be a ground supporting a notice of charges.

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51. What does and does not constitute a lack of prudent banking, which remains undefined for some fifty-nine (59) years, requires evidence more than the allegation of the FDIC examiners, so that examiners' ad hoc determinations not based on some regulatory issuances of the FDIC or evidence of experts other than FDIC employees is insufficient evidence to support charges that Bank committed unsafe and unsound acts because such was not prudent banking.

52. The Administrative Law Judge erred in the following respects contrary to 12 C.F.R. §308.36 regarding evidence:

a. Terminating Bank's cross-examination of Steven L. Jeffers on OREO. (I Ex. 288-289).

b. Denying the admission of the statistical summary attached to CBC's Exhibit 20. (I Ex. 154).

c. Denying the admission of CBC's Exhibit 67 such being the March 10, 1993 Interagency Policy constituting an admission against interest by the FDIC that it had not been conforming to the Interagency Policies contained in CBC's Exhibits 3, 3a, 6, and 7. (I Ex. 519).

d. Denying admission of CBC's Exhibits 65 and 66, such being the first and second proposed cease and desist orders submitted to the Bank. (I Ex. 506-508).

e. Denying admission of how successful the Bank has been with its present management over the last 25 years. (I Ex. 116-118).

f. The ALJ's sua sponte objection to Bank's question on loan policy being promulgated by the FDIC. (I Ex. 123-124).

g. Denying Bank's cross-examination of Riddick. (I Ex. 305).

h. Denying Bank's cross-examination of Jeffers. (I Ex. 93-95).

i. Denying Bank's cross-examination of Riddick. (I Ex. 422-423).

j. Denying Bank's cross-examination of Jeffers. (I Ex. 63-64).

k. Denying Bank's cross-examination of Jeffers. (I Ex. 91).

1. Denying Bank's cross-examination of Jeffers. (I Ex. 99-100).

m. Denying Bank's cross-examination of Jeffers. (I Ex. 71).

n. Denying Bank's cross-examination on inspections. (I Ex. 130-131, 416).

That said rulings on evidence were prejudicial preventing Bank from presenting its defenses to the fullest resulting in a lack of due process.

53. Bank's actions taken in good faith on regulatory issuances of

the FDIC cannot be a ground for or considered as evidence supporting proof of notice of charges.

54. The record here discloses that the field examiners and the review examiners have made a multitude of factual errors and failed to follow regulatory issuances or use those regulatory issuances available to them to avoid applying excessively rigorous examination standards so as to examine Bank in a consistent, prudent, and balanced fashion. The factual errors combined with the failure to apply regulatory issuances together with the withdrawal by the FDIC of a significant portion of the charges requires this Court to conclude that there is not substantial evidence to support any of the charges of unsafe and unsound banking practices. Accordingly, the notice of charges should be dismissed.

* * * *

9. This is at best a weird proceeding brought by the FDIC. The first thing it did was to eliminate from sub-standard classification $605,000 of Big Country Ford. At time of trial it eliminated charges of operating without liquidity, operating without an adequate investment policy, operating without proper funds management and interest rate risk. (I Ex. 336, 355-356, FDIC's Exhibit 18). All of the aforegoing being done under Bank's Manual, which FDIC still holds to be inadequate. Further, the FDIC now says no management changes are necessary. (I Ex. 355-356, 427-418). The classification of assets, loans and OREO remains a problem, despite the fact that the ALJ holds that the huge fraud and losses arising out of Curry County Grain & Elevator Co., Inc. and the resultant litigation costing over $1 million was not the fault of Bank. (Recommended Decision, p.25). Despite the alleged bad loans and OREO Bank admittedly

has excess capital. Neither the examiners nor the ALJ have been able to point to a single instance where their proposed cease and desist order would prevent or cure any of the alleged bad loans or OREO.

10. The truth of the matter is that the Dallas Regional Office made a mistake in the first instance which it is unwilling to acknowledge. It is a grand example of over-zealous bank examinations which both the prior and current national administrations are trying to rectify. The management of Bank has had more experience than any bank examiner, but has been intentionally ignored by them. This action cannot be categorized as anything less than arbitrary, capricious, an abuse of discretion, and contrary to law. The waste of time and energy is enormous for both parties. Bank asks only that the Board exercise some common sense which the FDIC Regional Office seems to lack.

WHEREFORE, it is prayed that the Notice of Charges be dismissed.

Respectfully submitted,

Lynell G. Skarda and Mickey D. Barnett of Barnett & Scott

By: s/ Lynell G. Skarda
Lynell G. Skarda

Appendix D

CERTIFICATE OF SERVICE

I, Lynell G. Skarda, do hereby certify that I did on the 25th day of August, 1993, with first class postage prepaid, mail a copy of the foregoing document to:

Arthur L. Beamon
Associate General Counsel
Compliance and Enforcement
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429-9990

Office of the Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429-9990

Judith K. Sinclair and Terry G. Youngblood
Federal Deposit Insurance Corporation
1910 Pacific Avenue, Suite 1900
Dallas, Texas 75201

New Mexico Director of Financial Institutions
Box 25101
Santa Fe, New Mexico 87504

s/ Lynell G. Skarda
Lynell G. Skarda

APPENDIX E — MOTION FOR STAY, NO. 94-1007

UNITED STATES COURT OF APPEALS

FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 94-1007

CITIZENS BANK OF CLOVIS,

Petitioner,

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

Respondent

MOTION FOR STAY

Pursuant to D.C. Cir. R. 18(a)(1), The Citizens Bank of Clovis, Petitioner herein, hereby respectfully moves this Court for an Order staying the provisions of the Order of the Federal Deposit Insurance Corporation [FDIC] dated December 7, 1993, and received by Petitioner December 16, 1993, pending completion of judicial review of said Order in the instant proceeding. Application for this relief has previously been made to the FDIC on January 27, 1994, but FDIC's counsel filed its objection thereto on February 4, 1994, so a further wait is a useless act as Bank's Motion will be denied.

1. The factors relied on for relief by this Court are as follows:

a. There is a great likelihood that the Bank will prevail

on the merits because it is self-evident that the FDIC does not follow its own rules, regulations, and policies, classifying loans that are secured and in other real estate [OREO] owned by Bank whose book value is supported by adequate appraisals, all with regard to a bank which is over-capitalized on the date of examination, at which time its capital ratios were as follows: (a) Tier 1 Leveraged Capital Ratio to Total Assets 2.34 times the 4% required; (b) Total Risk-Based Capital Ratio to Total Risk-Weighted Assets 2.15 times the required percentage; (c) Tier 1 Risk-Based Capital Ratio to Risk-Weighted Assets of 4.34 times the required ratio; (d) Primary Capital of 2.38 times the amount required by regulation.

That on December 31, 1993, Bank's capital ratios were even more, far in excess of those required by the FDIC's own regulation 12 C.F.R. Part 325 as shown by the following:

(1) Where Bank in its December 31, 1993, Report of Condition shows the following Capital Ratios, to-wit:

(a) Tier 1 Leverage Capital Ratio to Assets of 11.73% which is 2.93 times that required;

(b) Total Risk-Based Capital Ratio to Total Risk-Weighted Assets of 21.10% which is 2.64 times that required;

(c) Tier 1 Risk-Based Capital Ratio to Total Risk-Weighted Assets of 19.82% which is 4.95 times that required;

(d) Primary capital of 13.91% which is 2.53 times that required. In addition, primary

capital is $11.00 more than on July 5, 1991, at which time Tier 1 Leverage Capital Ratio was 9.36% which was 2.34 times the required 4%; Total Risk-Based Capital To Risk-Weighted Assets was 15.62% which was 2.15 times the required 7.25%; and Tier 1 Risk-Based Capital to Risk-Weighted Assets was 14.11% which was 4.34 times the required 3.25%.

(2) Although Bank disputes the FDIC's classification of assets, those classified assets are down to $21,463,000 on December 31, 1993, from $33,147,000 at the July 5, 1991, examination even with $8,352,000 of elevator OREO being included.

(3) Despite regulator required but unmerited charge-offs, Bank had a profit of $1,130,858 in 1993. This bank is doing well despite the huge fraud committed on it in 1986. Bank was notified January 26, 1994, that New Mexico's Supreme Court had affirmed Bank's foreclosure against Malcolm G. Garrett for some $2,000,000, which land has been sold.

(4) Of the $21,463,000 classified assets on Bank's last examination, August 27, 1993, $8,352,000 is from the 8,400,000 bushel grain elevators acquired by Bank in lieu of foreclosure. These elevators are income producing since acquired in 1987 yielding Bank in 1993 $725,948, which is 9.05% on Bank's book value of $8,017,920 with total cash flow of $997,435, which is 12.44% on that same book value. The FDIC has admitted in this litigation that it is legal for Bank to own and lease these elevators.

(5) In fact, if Bank charged-off the entire elevator book

value of $8,017,920 on December 31, 1993, with Tier 1 Capital of $16,639,000, Tier 2 Capital of $1,075,000, making Total Capital of $17,714,000, with Risk-Weighted Assets of $83,956,000, and Total Assets of $141,458,000, Bank's capital ratios would exceed those required by 12 C.F.R. Part 325 as follows:

(a) Tier 1 Leverage Capital Ratio to Total Assets of 6.1% being 1.52 times the required 4%;

(b) Total Risk-Based Capital Ratio to Total Risk-Weighted Assets of 11.5% which is 1.44 times the required 8%;

(c) Tier 1 Risk-Based Capital Ratio of 10.3% which is 2.57 times the required 4%.

(6) Bank's published Report of Condition for December 31, 1993, is attached hereto as Exhibit A and incorporated by reference the same as if set out in full.

b. There is a significant prospect of irreparable injury to Bank if relief is withheld because in addition to the considerable time and labor involved, the Order provides that the Bank shall increase its Board of Directors from 3 to 6, which requires CBC, Inc., the holding company owning all of Bank's stock, to amend its Articles of Incorporation in order to issue more stock and comply with 12 C.F.R. Part 325 as to bank stock and 12 C.F.R. Part 225 as to holding company stock when Bank is fully aware that such stock could not be sold to people to become directors because director and officer insurance is not available without a regulatory exclusion and requiring a deductible of $25,000 with a basic limit of only $1,000,000, when insurance companies have no interest in issuing such a policy where the

bank is under a cease and desist order as here regardless of a $30,000 to $40,000 premium.

c. There is no possibility of harm to other parties if relief is granted as the Bank is audited every year by an independent auditing firm, and there could be little if any doubt concerning its record keeping.

d. There is no damage to the public interest as the FDIC Act is not a public interest statute, the same as the Bank Holding Company Act which also has no public interest provision. *Dimension Financial Corporation v. Board of Governors of the Federal Reserve System,* 744 F.2d 1402 (Cir. 10, 1984), affirmed 474 U.S. 361, 106 S.Ct. 681, 88 L.Ed.2d 691 (1986).

2. Bank's counsel has talked to Dina L. Biblin, who is handling this appeal at the FDIC office in Washington, D.C., who advised counsel that she had no authority whatsoever to consent to a stay and that such would have to be obtained from the FDIC, whose rules do not provide for any such motion, which is the reason why Bank requested a stay from the FDIC knowing that such would be denied in all likelihood.

3. Copies of the FDIC's Decision and Order on Cease and Desist Proceeding and the ALJ's Recommended Decision adopted by the FDIC are attached as Exhibits B and C.

4. Counsel for the FDIC has been notified this day by telephone of this Motion, 2 copies being mailed by Federal Express.

WHEREFORE, The Citizens Bank of Clovis respectfully requests this Court for an Order staying the enforcement of the

Appendix E

Decision and Order on the Cease and Desist proceeding issued by the Federal Deposit Insurance Corporation dated December 7, 1993, pending judicial review.

LYNELL G. SKARDA
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STATE OF NEW MEXICO]
] ss.
COUNTY OF CURRY]

I, Lynell G. Skarda, do state that I have read the aforegoing Motion for Stay, and that said allegations and statements contained therein are true and correct to the best of my knowledge and belief.

s/ Lynell G. Skarda
LYNELL G. SKARDA

Subscribed and sworn to before me this 7th day of February, 1994.

My Commission Expires:
October 20, 1994

s/ Lucile Laughlin
NOTARY PUBLIC

CERTIFICATE OF SERVICE

I, Lynell G. Skarda, do hereby certify that I did on the 7th day of February, 1994, with first class postage prepaid, mail two copies of the aforegoing Motion for Stay to Dina L. Biblin, Attorney, Litigation Section, Federal Deposit Insurance Corporation, 550 17th Street, N.W., Washington, D.C., 20429-9990; and one copy to Robert I. LaGrange, New Mexico Director of Financial Institutions, Box 25101, Santa Fe, New Mexico, 87504.

s/ Lynell G. Skarda
LYNELL G. SKARDA

APPENDIX F — FDIC'S RESPONSE IN OPPOSITION TO MOTION FOR STAY PENDING APPEAL, NO. 94-1007

UNITED STATES COURT OF APPEALS
FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 94-1007

CITIZENS BANK OF CLOVIS,

Petitioner

v.

FEDERAL DEPOSIT INSURANCE CORPORATION

Respondent

FDIC'S RESPONSE IN OPPOSITION TO
MOTION FOR STAY PENDING APPEAL

The Federal Deposit Insurance Corporation ("FDIC") hereby objects to the Motion for Stay of Cease and Desist Order ("Motion") filed by the Petitioner Citizens Bank of Clovis ("CBC" or "the Bank").

The FDIC's Cease and Desist Order

On December 7, 1993, the FDIC Board of Directors ("FDIC Board") issued its Final Decision and Order on Cease and Desist Proceeding ("Decision" or "Cease and Desist Order") directing the Petitioner to Cease and Desist from certain unsafe or unsound banking practices and violations of laws, rules and regulations. Copy found at Exhibit B to Petitioner's Motion. The FDIC's

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Decision followed a hearing on the record, extensive briefing and document submissions by the Petitioner and the FDIC, and a Recommended Decision by the Administrative Law Judge ("ALJ"), attached as Exhibit C to Petitioner's Motion. The findings and conclusions of the ALJ were adopted in full by the FDIC Board. Petitioner's Exhibit B at 2.

The Bank was charged with unsafe or unsound practices including maintaining inadequate loan policies, extending loan due dates without requiring additional collateral or payment of interest, maintaining an excessive volume of adversely classified loans, failing to maintain adequate reserves and using poor management with insufficient supervision by the Bank's board of directors. FDIC Board Decision at 1. [Exhibit B to Petitioner's Motion]. The FDIC Board ordered Petitioner to cease and desist from, *inter alia,* operating the bank without adequate loan policies, renewing loans without collecting interest due or obtaining adequate collateral, operating the Bank with an excessive level of adversely classified assets, failing to provide an adequate allowance for loan and lease losses, operating the Bank in violation of applicable laws and regulations, engaging in hazardous lending and lax collection practices, operating the Bank with management whose policies and practices are detrimental to the Bank and jeopardize the safety of its deposits; and operating the Bank without adequate supervision and direction by the Bank's Board of Directors over the Bank management. *Id.* at 7-8. In addition to the cease-and-desist portion of the Order, the Bank also was ordered to develop and implement adequate lending and collection policies, eliminate from its books, by charge-off or collection, all assets identified as "Doubtful" by the FDIC as a result of its 1991 examination of the Bank, increase its loan and lease losses allowance, establish a loan review committee to review the Bank's loan portfolio and

identify and categorize problem credits, refrain from paying cash dividends to shareholders without the prior written consent of the Regional Director[1], and refrain from extending additional credit for the benefit of borrowers who are already in default or whose loans are classified as "Doubtful". *Id.* at 8-15. The Order also requires CBC to appoint qualified management, appoint independent, outside directors who do not control more than 5% of the voting stock of the Bank, are not borrowers of over $500,000 of CBC, and are unrelated to the current management and directors.[2] Other parts of the Order more specifically set forth internal procedures for the Bank to comply with the substantive provisions of the Cease and Desist Order, including setting up compliance committees, notifying the shareholders, and reporting to the FDIC's Regional Director on CBC's progress in compliance. *Id.* at 16-18.

Exhaustion of Administrative Remedies

On January 29, 1994, CBC filed a Motion for stay with the FDIC, which was denied on February 15, 1994.[3] Concurrently,

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1. It should be noted that counsel for the Petitioner, Lynell Skarda, is chairman of the three-member CBC board of directors and the controlling influence at the institution. He is also the largest shareholder, owning 33.33% of the total shares. FDIC Report of Examination, 1991. CBC's Motion for Leave to File oversized Brief at ¶ 5. He is, therefore, personally affected by every aspect of the FDIC Decision and Order.

2. It is this provision, in particular, that CBC claims triggers its "irreparable harm" for the purpose of this Motion. Two of the three members of the current Board of Directors are Lynell Skarda and his brother, Langdon Skarda.

3. The Petitioner's motion before the FDIC alleged nearly the identical argument set forth at Argument #1.(a.) of Petitioner's pending Motion before this Circuit.

CBC filed with the D.C. Circuit this motion for stay pending appeal on February 7, 1994.[4]

ARGUMENT

PETITIONER HAS NOT JUSTIFIED ISSUANCE OF A STAY OF THE CEASE AND DESIST ORDER PENDING JUDICIAL REVIEW

The leading law in this Circuit dictates that four factors are to be considered in determining whether a stay is warranted:

> (1) the likelihood that the party seeking the stay will prevail on the merits of the appeal; (2) the likelihood that the moving party will be irreparably harmed absent a stay; (3) the prospect that others will be harmed if the court grants the stay; and (4) the public interest in granting the stay.

Virginia Petroleum Jobbers Ass'n. v. FPC, 259 F.2d 921, 925 (D.C. Cir. 1958), cited in *Wisconsin Gas Company v. Federal Energy Regulatory Commission,* 758 F.2d 669, 673-74 (D.C. Cir. 1985). The burden is on the movant to demonstrate either a combination of probable success and the possibility of irreparable injury or that serious questions are raised and the balance of hardships tips sharply in his favor. *Virginia Petroleum Jobbers Ass'n v. FPC, supra* at 844, citing *Charlie's Girls, Inc. v.*

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4. At the time CBC filed the Motion before this Circuit, it was premature. [F.R.A.P. 18.] On February 16, 1994, the day after the FDIC denied CBC's motion for stay pending appeal in the administrative forum, the Respondent FDIC filed a stipulated motion for extension of time to respond to CBC's Motion in this proceeding.

Revlon, Inc., 483 F.2d 953, 954 (2nd Cir. 1973) (per curiam). As discussed below, Petitioner fails to meet this burden.[5]

I. *Petitioner has not demonstrated a likelihood it will prevail on the merits.*

This Court's review of the final agency action should affirm the FDIC Board action unless the findings upon which it is based are not supported by substantial evidence on the record as a whole or unless the remedies formulated by the Board constitute an abuse of discretion or are otherwise arbitrary and capricious. *Sunshine State Bank* at 1584; *Bank of Dixie v. FDIC*, 766 F.2d at 178. See *also, Gold Coast Restaurant Corp. v. NLRB*, 995 F.2d 257, 263 (D.C. Cir. 1993); *Community Nutrition Institute v. Young*, 773 F.2d 1356, 1362-63 (D.C. Cir. 1985).

To demonstrate that it is likely to prevail on the merits, CBC states that it has a high capital level and the number of its adversely classified assets have decreased.[6] Motion at 2-4.

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5. Consistent with the law of this Circuit, the FDIC's statute providing for judicial review states that

> The commencement of proceedings for judicial review under paragraph (2) of this subsection shall not, unless specifically ordered by the court, operate as a stay of any order issued by the agency.

12 U.S.C. § 1818(h)(3). This language suggests that Congress intended a stay of FDIC final orders to be the exception and not the rule.

6. The assessment of an adverse classification to an asset by an FDIC Examiner is an expression of the degree of risk to CBC that a certain loan or other obligation owed to CBC will not be fully paid in accordance with its stated terms.

Notably, CBC does not state that it has ceased the unsafe or unsound practices addressed in the Decision. The Bank also alleges, without providing any support, that it is "self-evident" that the FDIC did not follow its own rules, regulations, and policies with regard to its assessment of the Bank's assets as unsatisfactory. Motion at 2.

None of these allegations support a likelihood that the Bank will prevail on the merits. Even if the Bank's offending practices have ceased or been corrected, this would not be a basis for stay of a corrective order such as this one, nor is it a signal that the FDIC's actions in ordering the Bank to cease and desist were "arbitrary and capricious". *First State Bank of Wayne County v. FDIC,* 770 F.2d 81, 82-83 (6th Cir. 1985). Rather, evidence of the Bank's improved compliance with the law goes toward compliance with the Order to Cease and Desist. *Bank of Dixie v. FDIC,* 766 F.2d 175, 178 (5th Cir. 1985). A determination whether the Bank has abandoned or corrected the offending practices is appropriately made in the course of subsequent bank examinations, not in a Petition for Review of a cease-and-desist order. *Id.*

In another case which challenged an FDIC Cease-and-Desist Order on similar grounds, the Sixth Circuit Court of Appeals stated:

> . . . assuming the Bank has improved its loan policy, the facts of this case warrant the entry of a cease and desist order to prevent future abuses. . . . Such an order is an appropriate instrument to deter and prevent future abuses and to correct conditions which have resulted from the unsafe and unsound practices and

violations and to protect the shareholders of the Bank and insure their security in the future.

First State Bank of Wayne County v. FDIC, 770 F.2d at 82-83.

Similarly, the Bank's baseless suggestion that the FDIC did not apply its own rules in evaluating the Bank does not establish a likelihood of success on the merits. To the contrary, the ALJ and the FDIC Board supported their respective decisions with specific and extensive findings of fact based upon the FDIC Reports of Examination, testimony, numerous exhibits, and facts stipulated by both parties. ALJ Recommended Decision at 4-14, 19-31, 34-38. [Exhibit C to Petitioner's Motion]. The dispute in the administrative proceeding went chiefly to CBC's refusal to accept the judgment of the FDIC Bank Examiners in evaluating the "safety and soundness" of the Bank's operations. *Id.* at 40. Not only was the decision based on substantial evidence, but the FDIC Examiners' discretionary evaluations are entitled to deference on appeal. *Sunshine State Bank v. FDIC*, 783 F.2d 1580, 1582-1584 (11th Cir. 1986); *Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984).

Given the record below, the Petitioner has failed to show a likelihood of success on the merits.

II. *Petitioner has not demonstrated irreparable injury unless the stay is granted.*

Petitioner alleges "irreparable injury to Bank if relief is withheld", based on the time and labor required to comply with the FDIC's directive that the Bank increase the number of its

directors from three to six.[7] Motion at 4-5. This allegation is hardly the type of irreparable injury required to justify a stay. As this Court stated in *Virginia Petroleum Jobbers Ass'n v. FPC*, 259 F.2d at 925:

> The key word in this consideration is irreparable. Mere injuries, however substantial, in terms of money, time and energy necessarily expended in the absence of a stay are not enough.

quoted in *Wisconsin Gas Co. v. FERC, supra*, 758 F.2d at 674.

The Bank's alleged "injury" does not constitute a loss "which threatens the very existence of the movant's business". *Id.* The Cease and Desist Order calls for relatively modest relief. As was explained by the ALJ:

> [FDIC] wants no more than to have CBC cease and desist from unsafe or unsound practices which will inure to its disadvantage and threaten the Insurance Fund. FDIC is not demanding any capital infusion or seeking a penalty, but rather wants no more than a reform of CBC's banking practices and the ability to supervise these changes. Enforcement counsel has met its burden of

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7. The FDIC Cease and Desist Order does not require a literal increase from three to six, but rather, requires that new directors be appointed so that 50% of the directors are "outside" directors, without substantial equity holdings, debts, or other relation to the Bank. Since there currently are three directors at CBC, minimum compliance would require appointment of three more without removing one of the current members.

> proof by a preponderance of the evidence, and has effectively proven that the proposed changes are warranted.

ALJ Recommended Decision at 41. [Exhibit C to Petitioner's Motion.] If anything, it is the FDIC Cease and Desist Order — requiring the Bank to continue its operations, albeit in a lawful, safe and sound manner — which preserves the "status quo", not Petitioner's request for a stay pending a final determination of the merits of the suit. *Compare, Washington Metropolitan Area Transit Authority v. Holiday Tours,* 559 F.2d 841, at 844 (D.C. Cir. 1977).

In sum, the Bank can point to no irreparable injury in being required to comply with the FDIC Decision. When viewed together with the likelihood that Petitioner will not ultimately succeed in this appeal, this factor clearly merits against a stay pending judicial review.

> III. *Granting a stay of the Cease and Desist Order may cause substantial harm to other interested persons.*

Petitioner claims the stay would not harm any other persons because the Bank is audited every year by an independent auditing firm. This allegation misses the point. The Bank already is (and was, during the period addressed by the 1991 Report of Examination) required by state law to submit an independent audit and by state and federal law to submit a certified report of condition to the regulators each year. 12 U.S.C. § 1817; N.M. Stat. Ann. § 58-166(D). These reports are not meant to replace the authority of the FDIC to enforce the Federal Deposit Insurance Act.

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Under both federal and state law, the chief responsibility for carrying out the annual audit is on the Board of Directors of the Bank.[8] The FDIC found that CBC's self-policing resulted in unsafe and unsound banking practices, notwithstanding annual audits by an accounting firm, thus necessitating the Cease and Desist Order. As stated by the ALJ, below:

> Management's policies and practices have served the bank adequately up to this point. However, FDIC has presented a solid case for necessary reforms to ensure the continued safety of CBC and the continued safety of the Insurance Fund. The FDIC charges CBC with operating policies detrimental to CBC and thus constituting unsafe and unsound banking practices, including operating with poor management. Management received a 4 rating during the July 5, 1991 examination. (TR Vol. III, p. 48; Vol IV, p. 132).

ALJ Decision at 18.[9] [Exhibit C to Petitioner's Motion.]

In short, an annual audit would not resolve the problems which are corrected by the Cease and Desist Order. The ALJ found that in the absence of the Cease and Desist Order, CBC's banking operations would result in an abnormal risk of loss or

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8. The FDIC's reporting requirements were amended by Congress in 1991 and now require CBC to submit to FDIC an independent audit as well as the report of financial condition. 12 U.S.C. § 1831m(d).

9. The "4" rating is a component of the CAMEL rating which is a composite of an institution's capital, asset, management, earnings, and liquidity. 1 is the highest rating and 5 is the lowest. ALJ Decision at 18, n.4.

damage to the institution which affects the Bank's stockholders and depositors. ALJ Recommended Decision at 41. Therefore, a stay pending appeal has the potential for harming other interested persons who have a stake in this Bank.

IV. *The public interest will be harmed if a stay is granted.*

For the same reasons stated above, the public interest will be harmed if a stay is granted. If the Bank continues its unsafe and unsound operations, without being required by the Cease and Desist order to improve its lending and management operations, the FDIC's Insurance Fund, as well as stockholders and depositors of CBC, could sustain a loss.

CBC's allegation [Motion at 5] suggesting that enforcement of safety and soundness requirements under the Federal Deposit Insurance Act is not in the public interest is absurd. The FDIC is entrusted with the task of regulating and insuring financial institutions in order to promote the stability of and confidence in the nation's banking system for the benefit of the public. *Gunter v. Hutcheson,* 674 F.2d 862, 870 (11th Cir. 1982), *cert. denied,* 103 S.Ct. 60, *reh. denied,* 103 S.Ct. 477 (1982); *First State Bank of Hudson County v. U.S.,* 599 F.2d 558, 562-63 (3d Cir. 1979); *cert. denied,* 100 S.Ct. 662 (1980); *Doherty v. United States,* 94 F.2d 495, 497 (10th Cir.), *cert. denied,* 58 S.Ct. 763 (1938).

The statute provides the FDIC with authority to issue cease and desist orders if a violation of law or *any* unsafe or unsound practice has been established. 12 U.S.C. § 1818(b)(1); *First State Bank of Wayne County v. FDIC,* 770 F.2d at 83. The FDIC Board's Decision is intended to allow the FDIC not only to halt and correct current or former practices but also to prevent future

abuses that could result in further deterioration of a bank's financial condition. Without that Order, the FDIC has no assurance that if CBC were free of the restraint it would not continue its former course. *Bank of Dixie v. FDIC,* 766 F.2d at 178.

The public interest is not served by compromising the FDIC's ability to enforce its safety and soundness requirements, simply because it is an inconvenience for regulated banks to comply with the law. The public interest is best served by denying the Petitioner's Motion for Stay pending appeal.

CONCLUSION

There is no factual or legal basis upon which a stay pending appellate review should be granted. For the foregoing reasons, the FDIC asks that this Court deny Petitioner's Motion for Stay Pending Appeal.

February 25, 1994

Respectfully submitted,

THOMAS A. SCHULZ
Assistant General Counsel

COLLEEN B. BOMBARDIER
Senior Counsel

s/ Dina L. Biblin
DINA L. BIBLIN
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FEDERAL DEPOSIT
INSURANCE CORPORATION

Appendix F

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Attorneys for Respondent

CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing was mailed, overnight (weekday) delivery, postage prepaid, on February 25, 1994 to:

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s/ Dina L. Biblin
Dina L. Biblin

APPENDIX G — ORDER DENYING MOTION FOR STAY, NO. 94-1007

UNITED STATES COURT OF APPEALS FOR THE DISTRICT OF COLUMBIA CIRCUIT

No. 94-1007 **September Term, 1993**

Citizens Bank of Clovis, a New Mexico Corporation,

Petitioner

v.

Federal Deposit Insurance Corporation,

Respondent

BEFORE: Edwards, Williams and Sentelle, Circuit Judges

ORDER

Upon consideration of the motion for a stay and the opposition thereto, and the motion to file oversize brief and the opposition thereto, it is

ORDERED that the motion for a stay be denied. Petitioner has not satisfied the stringent standards required for a stay pending court review. *See Washington Metropolitan Area Transit Commission v. Holiday Tours, Inc.*, 559 F.2d 841, 843 (D.C. Cir. 1977); *D.C. Circuit Handbook of Practice and Internal Procedures* 68-69 (1994). It is

FURTHER ORDERED that the motion to file oversize brief be denied.

Appendix G

Per Curiam

s/ HE
SFW
DS

Filed: March 21, 1994

APPENDIX H — LOAN CLASSIFICATION, MEP, P. 3.1-22

Loan Classification

To quantify and communicate the results of the loan appraisal, the examiner must arrive at a decision as to which loans are to be subjected to criticism and/or comment in the examination report. Adversely classified loans are allocated on the basis of risk to three categories:

1. Substandard;

2. Doubtful; and

3. Loss.

Other loans of questionable quality, but involving insufficient risk to warrant classification, are designated as Special Mention loans. Loans lacking technical or legal support, whether or not adversely classified, should be brought to the attention of the bank's management. If the deficiencies in documentation are severe in scope or volume, a schedule of such loans should be included in the report of examination.

Loan classifications are expressions of different degrees of a common factor, risk of nonpayment. All loans involve some risk, but the degree varies greatly. It is incumbent upon examiners to avoid classification of sound loans. The practice of lending to sound businesses or individuals for reasonable periods is a legitimate banking function. Adverse classifications should be confined to those loans which are unsafe for the investment of depositors' funds.

A revised statement on classification of bank assets and appraisal of securities in bank examinations was issued jointly on May 7,

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1979, by the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Conference of State Bank Supervisors. This statement, a revision of an agreement issued in 1938 and revised July 15, 1949, clarifies definitions and eliminates practices duplicated elsewhere. It provides expanded definitions of "Substandard", "Doubtful", and "Loss" categories used for criticizing bank assets. Fifty percent of the total of "Doubtful" and all of "Loss" are to be deducted in computing the net sound capital (adjusted capital and reserves) of the bank. Amounts classified "Loss" should be promptly eliminated from the bank's books.

Uniform guidelines have been established by the Division regarding the examination report treatment of assets classified "Doubtful". The general policy is **not** to require charge-off or similar action for Doubtful. Examiners should make a statement calling for a bank to charge-off a portion of loans classified Doubtful **only** when State law or policy requires. Further, any such statement should be clear as to its intended purpose of bringing the bank into conformity with those State requirements. An exception is made for formal actions under Section 8 of the FDI Act. A statement addressing the charge-off of loans classified Loss will continue to be a required comment on the Examiner's Comments and Conclusion schedule. Unchanged is the procedure for deducting all Loss and 50% of the amount of Doubtful in computing adjusted primary capital of the bank.

The above policy position concerning disposition of Doubtful assets also states that a careful assessment of the adequacy of the loan valuation reserve be made. This assessment may begin with an evaluation of the bank's procedures, or absent these, examiners will need to develop their own approaches for making the analysis. Regardless of the method chosen, it is essential that

provision be made for all risk of loss in the portfolio, both identified and unidentified. Loans classified in the examination report may be used to develop a measure for identifying problem loans, and, as a part of this process, the examiner may assign a 50% loss factor for loans classified Doubtful. After adjustments are made for Loss and one-half of the amount of Doubtful, peer averages may serve as a point of reference for the level of the reserve. Factors such as the volume and severity of adversely classified loans, management policies and capabilities, asset quality trends, portfolio strategies, charge-off and collection practices, and local and general economic conditions must be considered to support the examiner's determination as to the appropriate level for the loan loss reserve. It is unlikely peer averages **alone** would be sufficient to determine what an adequate level should be. If, after the foregoing assessment, it is determined the level of the reserve is inadequate, recommendation for correction should be made on the Examiner's Comments and Conclusions schedule. This comment should emphasize the need for an ongoing internal review program of asset quality and adequacy of the valuation reserve and provisions for timely recognition of losses, propriety of cash dividends, and integrity of published financial data. Any deficiency determined by the examiner should be corrected by the next reporting period or within a reasonable time frame, although not later than the bank's fiscal year-end.

Definitions

Substandard –- Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct

possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful — Loans classified Doubtful have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently known facts, conditions and values, highly questionable and improbable.

Loss — Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

There is a close relationship between classifications, and no classification category should be viewed as more important than the other. The uncollectibility aspect of Doubtful and Loss classifications makes their segregation of obvious importance. The function of the Substandard classification is to indicate those loans which are unduly risky and may be a future hazard to the bank's solvency. No bank can safely hold a large amount of low quality loans, even though they are not presently subject to either a Doubtful of Loss classification.

A complete list of adversely classified loans is to be provided management, either during or at the close of an examination. This is especially true in those situations when total asset classifications amount to 25% or less of a bank's total equity capital and reserve accounts and the examination discloses no material problems or trends in the area of loan administration. In these instances, the Assets Subject to Adverse Classification schedule may be deleted.

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Special Mention — Included in this category are loans which do not presently expose the bank to a sufficient degree of risk to warrant adverse classification but do possess credit deficiencies deserving management's close attention. Failure to correct deficiencies could result in greater credit risk in the future. Ordinarily, such borderline credits have characteristics which corrective management action would remedy. Often in credit lines warranting Special Mention, it is the bank's weak origination and/or servicing policies which constitute the cause for criticism. The nature of this category of loan criticism precludes inclusion of smaller lines of credit unless those loans were part of a large grouping listed for related reasons.

Examiners should not misconstrue the fact that most specially mentioned loans contain management correctable deficiencies to mean that loans merely involving technical exceptions belong in this category. However, instances may be encountered where technical deficiencies are a factor in scheduling loans for Special Mention. This category is not to be utilized as a means of avoiding a clear-cut decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, coupled with large size, create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loan for Special Mention is not justified. Careful identification of loans which properly belong in this category is important in determining the extent of risk in the bank's loan portfolio and providing constructive criticism for bank management.

Basically, comments appended to loans listed for Special Mention should be drafted in a fashion very similar to those for classified loans. There is no less of a requirement upon the

examiner to record clearly the reason(s) why the loan is listed. The major thrust of the comments should be in the direction of achieving correction of the deficiencies identified in the line.

Troubled Commercial Real Estate Loan Classification Guidelines

Additional classification guidelines have been developed to aid the examiner in classifying troubled commercial real estate loans. These guidelines are intended to supplement the uniform guidelines discussed above.

After performing an analysis of the project and its appraisal, the examiner must determine the classification of any exposure. The following guidelines are to be applied in instances where the obligor is devoid of other reliable means of repayment, with support of the debt provided solely by the project. If other types of collateral or other sources of repayment exist, the project should be evaluated in light of these mitigating factors.

Substandard — Any such troubled real estate loan or portion thereof should be classified Substandard when well-defined weaknesses are present which jeopardize the orderly liquidation of the debt. Well-defined weaknesses include a project's lack of marketability, inadequate cash flow or collateral support, failure to complete construction on time or the project's failure to fulfill economic expectations. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Doubtful — Doubtful classifications have all the weaknesses inherent in those classified Substandard with the added characteristic that the weaknesses make collection or liquidation

in full, on the basis of currently known facts, conditions and values, highly questionable and improbable. A Doubtful classification may be appropriate in cases where significant risk exposures are perceived, but loss cannot be determined because of specific reasonable pending factors which may strengthen the credit in the near term. Examiners should attempt to identify loss in the credit where possible thereby limiting the excessive use of the Doubtful classification.

Loss — Advances in excess of calculated current fair value which are considered uncollectible and do not warrant continuance as bankable assets. There is little or no prospect for near term improvement and no realistic strengthening action of significance pending.

Technical Exceptions

Technical deficiencies in documentation of loans should be brought to the attention of management for remedial action. Failure of management to effect corrections may lead to the development of greater credit risk in the future. Moreover, the presence of an excessive number of technical exceptions is a reflection on management's quality and ability. During the course of the examination, management should be furnished with a listing of loans which posses technical deficiencies. Such a procedure is intended to expedite early correction of the deficiencies and, in normal circumstances, inclusion of such exceptions in the report will be unnecessary. However, when spot checks reveal an excessive volume of deficiencies in loans under the cut-off point, examiners should insert the applicable technical exceptions page in the report of examination. Such a procedure adds emphasis to the importance of the documentation as well as providing support for the Examiner's Comments and

Conclusions schedule. Regardless of the size of the loan, existence of an inordinate number of technical defects should be emphasized.

Past Due and Nonaccrual

Overdue loans are not necessarily subject to adverse criticism. Nevertheless, a high volume of overdue loans almost always indicates liberal credit standards, weak servicing practices, or both. Because loan renewal and extension policies vary among banks, comparison of their delinquency ratios may be misleading. A more significant method of evaluating this factor lies in determination of the trend within the bank under examination, keeping in mind the distortion resulting from seasonal influences, economic conditions, or the timing of examinations. It is important for the examiner to carefully consider the makeup and reasons for the volume of overdue loans. Only then can it be determined whether the volume of past due paper is a significant factor reflecting adversely on the quality or soundness of the overall loan portfolio or the efficiency and quality of management. It is important that overdue loans be computed on a uniform basis. This allows for comparison of overdue totals between examinations and/or with other banks.

For purposes of the report of examination, overdue loans are separated into two distinct groupings: (1) All loans and leases which are 30 through 89 days past their maturity, or on which either interest or principal is due and unpaid for a period of 30 through 89 days, including unplanned overdrafts; (2) All other loans and leases which are 90 days or more past their maturity, or on which either interest or principal is due and unpaid for a period of 90 days or more, including unplanned overdrafts. In the case of installment credit, a loan will not be considered overdue until at

least two monthly payments are delinquent. The same will apply to real estate mortgage loans, term loans or any other loans payable on regular monthly installments of principal and/or interest. Overdue figures should include the number and total dollar balance of all loans which are not current. Efforts to show only the dollar amount of delinquent payments, as in the case of installment loans, result in figures of dubious value.

Some modification of the overdue criteria may be necessary because of applicable State law, joint examinations, or unusual circumstances surrounding certain kinds of loans or in individual loan situations. It will always be necessary for the examiner to ascertain the bank's renewal and extension policies and procedures for collecting interest prior to determining which loans are overdue, since such practices often vary considerably from bank to bank. This is important not only to validate which loans are actually overdue, but also to evaluate the soundness of such policies. Standards for renewal should be aimed at achieving an orderly liquidation of loans and not at maintaining a low ratio of past due paper through unwarranted extensions or renewals.

In larger departmentalized banks or banks with large branch systems, it may be informative to analyze delinquencies by determining the source of overdue loans by department or branch. This is particularly true if a large volume of overdue loans should exist. The production of schedules reflecting overdue loans by department or branch is encouraged if it will aid in pinpointing the source of a problem or be informative from the standpoint of supervision of the bank.

Continuing to accrue income on assets which are in default as to principal and interest overstates a bank's assets, earnings and

capital. Instructions for the Preparation of Reports of Condition and Income indicate, in summary, that where the period of default of principal or interest equals or exceeds 90 days, the accruing of income should be discontinued unless the asset is well-secured and in process of collection. Banks are strongly recommended to follow this guideline not only for reporting purposes but also bookkeeping purposes. There are several exceptions, modifications and clarifications to this general standard. First, consumer loans and real estate loans secured by one-to-four family residential properties are exempt from the nonaccrual guidelines. Nonetheless, these exempt loans should be subject to other alternative methods of evaluation to assure the bank's net income is not materially overstated. Second, any State statute, regulation or rule which imposes more stringent standards for nonaccrual of interest should take precedence over these instructions. Third, reversal of previously accrued but uncollected interest applicable to any asset placed in a nonaccrual status, and treatment of subsequent payments as either principal or interest, should be handled in accordance with generally accepted accounting principles. Acceptable accounting treatment includes reversal of all previously accrued but uncollected interest against appropriate income and balance sheet accounts.

APPENDIX I — SPECIAL MENTION, MEP, P. 3.1-23

Special Mention — Included in this category are loans which do not presently expose the bank to a sufficient degree of risk to warrant adverse classification but do possess credit deficiencies deserving management's close attention. Failure to correct deficiencies could result in greater credit risk in the future. Ordinarily, such borderline credits have characteristics which corrective management action would remedy. Often in credit lines warranting Special Mention, it is the bank's weak origination and/or servicing policies which constitute the cause for criticism. The nature of this category of loan criticism precludes inclusion of smaller lines of credit unless those loans were part of a large grouping listed for related reasons.

Examiners should not misconstrue the fact that most specially mentioned loans contain management correctable deficiencies to mean that loans merely involving technical exceptions belong in this category. However, instances may be encountered where technical deficiencies are a factor in scheduling loans for Special Mention. This category is not to be utilized as a means of avoiding a clear-cut decision to classify a loan or pass it without criticism. Neither should it include loans listed merely "for the record" when uncertainties and complexities, coupled with large size create some reservations about the loan. If weaknesses or evidence of imprudent handling cannot be identified, inclusion of such loan for Special Mention is not justified. Careful identification of loans which properly belong in this category is important in determining the extent of risk in the bank's loan portfolio and providing constructive criticism for bank management.

Basically comments appended to loans listed for Special Mention should be drafted in a fashion very similar to those for classified loans. There is no less a requirement upon the examiner to record

clearly the reason(s) why the loan is listed. The major thrust of the comments should be in the direction of achieving correction of the deficiencies identified in the line.

APPENDIX J — FINANCIAL REGULATORS ISSUE JOINT SUPERVISORY POLICY STATEMENT, NOVEMBER 7, 1991

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

NEWS RELEASE

EMBARGOED FOR RELEASE at 2 p.m. EST — PR-168-91
Thursday, November 7, 1991 — FIL-54-91

FINANCIAL REGULATORS ISSUE JOINT SUPERVISORY POLICY STATEMENT

WASHINGTON, D.C., Nov. 7, 1991 — The four federal regulators of bank and thrift institutions issued a joint statement today on the review and classification of commercial real estate loans. Today's action is another step by the agencies to ensure that misunderstandings about supervisory policies do not impede the availability of credit to sound borrowers. Development of this document was announced in the Administration's October 8th statement on "Easing The Credit Crunch To Promote Economic Growth."

The policy statement provides clear and comprehensive guidance on the review and classification of commercial real estate loans. The detailed guidelines, which will be sent to the chief executive officer of each depository institution and each bank and thrift examiner, cover loan portfolio review procedures, indicators of troubled loans, analysis of loans and collateral values, and the review of institutions' loss allowances.

Appendix J

The four regulatory agencies that issued today's guidelines are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,200 thrift institutions.

In addition to today's issuance, the regulatory agencies are undertaking three other actions:

- *National Meeting of Examiners*

  The agencies will hold a national meeting of senior examination personnel in Baltimore, Md., on December 16 and 17 to review the policy statement and other initiatives related to credit availability.

- *Random Audit Program*

  To assess the quality of examiners' review of collateral value, the regulatory agencies will implement a random audit program to determine how examiners review and analyze the assumptions contained in appraisals as part of their loan review process.

- *Holding Company Preferred Stock*

  The Federal Reserve Board, in a move designed to grant bank holding companies greater flexibility in raising capital, has issued for public comment a proposal to lift the limit on the amount of

noncumulative perpetual preferred stock that bank holding companies may include in Tier 1 capital. This proposal, if adopted, can assist organizations in strengthening their capital positions and expanding their ability to extend credit to sound borrowers.

All of these steps follow previous actions by the regulatory agencies in March and July to address credit availability concerns.

# # #

Attachment

Distribution: FDIC-Supervised Banks (Commercial and Savings)

Appendix J

Office of the Comptroller of the Currency
Federal Deposit Insurance Corporation
Federal Reserve Board
Office of Thrift Supervision

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans

November 7, 1991

The recent decline in credit extended by depository institutions has been attributed to many factors. These factors include the general slowdown in the economy, the overbuilding of commercial real estate properties in some markets, the desire of some household and business borrowers, as well as some depository institutions, to strengthen their balance sheets, changes by lenders in underwriting standards, and concerns about the potential impact of certain supervisory policies or actions. To ensure that regulatory policies and actions do not inadvertently curtail the availability of credit to sound borrowers, the four Federal regulators of banks and thrifts have taken a number of steps to clarify and communicate their policies. The attached policy statement is a further step in this effort.

On March 1, 1991, the four agencies — the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision issued general guidelines that addressed a wide range of supervisory policies. Included in the March issuance were brief discussions of the workout of problems loans, lending by undercapitalized institutions, and a general statement on the valuation of real estate loans.

Appendix J

The attached policy statement expands upon the March 1 and subsequent guidance as it relates to the review and classification of commercial real estate loans.

The intent of the statement by the agencies is to provide clear and comprehensive guidance to ensure that supervisory personnel are reviewing loans in a consistent, prudent, and balanced fashion and to ensure that all interested parties are aware of the guidance.

The policy statement emphasizes that the evaluation of real estate loans is not based solely on the value of the collateral, but on a review of the borrower's willingness and capacity to repay and on the income-producing capacity of the properties.

The policy statement also provides guidance on how supervisory personnel analyze the value of collateral. In general, examiners consider the institution's appraisals of collateral (or internal evaluations, when applicable) to determine value and they review the major facts, assumptions and approaches used in determining the value of the collateral. Examiners seek to avoid challenges to underlying assumptions that differ in only a limited way from norms that would generally be associated with the property under review. Nonetheless, when reviewing the value of the collateral and any related management adjustments, examiners ascertain that the value is based on assumptions that are both prudent and realistic, and not on overly optimistic or overly pessimistic assumptions.

The policy statement covers a wide range of specific topics, including:

- the general principles that examiners follow in reviewing commercial real estate loan portfolios;

- the indicators of troubled real estate markets, projects, and related indebtedness;

- the factors examiners consider in their review of individual loans, including the use of appraisals and the determination of collateral value;

- a discussion of approaches to valuing real estate, especially in troubled markets;

- the classification guidelines followed by the agencies, including the treatment of guarantees; and

- the factors considered in the evaluation of an institution's allowance for loan and lease losses.

This statement is intended to ensure that all supervisory personnel, lending institutions and other interested parties have a clear understanding of the agencies' policies.

Appendix J

Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans[1]

Introduction

This policy statement addresses the review and classification of commercial real estate loans by examiners of the federal bank and thrift regulatory agencies.[2] Guidance is also provided on the analysis of the value of the underlying collateral. In addition, this policy statement summarizes principles for evaluating an institution's process for determining the appropriate level for the allowance for loan and lease losses, including amounts that have been based on an analysis of the commercial real estate loan portfolio.[3] These guidelines are intended to promote the prudent,

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1. For purposes of this policy statement, "commercial real estate loans" refers to all loans secured by real estate, except for loans secured by 1-4 family residential properties. This does not refer to loans where the underlying collateral has been taken solely through an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien.

2. The agencies issuing this policy statement are the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

3. For analytical purposes, as part of its overall estimate of the allowance for loan and lease losses (ALLL) management may attribute a portion of the ALLL to the commercial real estate loan portfolio. However, this does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

For savings institutions, the ALLL is referred to as the "general valuation allowance" for purposes of the Thrift Financial Report.

balanced, and consistent supervisory treatment of commercial real estate loans, including those to borrowers experiencing financial difficulties.

The attachments to this policy statement address three topics related to the review of commercial real estate loans by examiners. The topics include the treatment of guarantees in the classification process (Attachment 1); background information on the valuation of income-producing commercial real estate loans in the examination process (Attachment 2); and definitions of classification terms used by the federal bank and thrift regulatory agencies (Attachment 3).

Examiner Review of Commercial Real Estate Loans

Loan Policy and Administration Review. As part of the analysis of an institution's commercial real estate loan portfolio, examiners review lending policies, loan administration procedures, and credit risk control procedures. The maintenance of prudent written lending policies, effective internal systems and controls, and thorough loan documentation are essential to the institution's management of the lending function.

The policies governing an institution's real estate lending activities must include prudent underwriting standards that are periodically reviewed by the board of directors and clearly communicated to the institution's management and lending staff. The institution must also have credit risk control procedures that include, for example, prudent internal limits on exposure, an effective credit review and classification process, and a methodology for ensuring that the allowance for loan and lease losses is maintained at an adequate level. The complexity and scope of these policies and procedures should be appropriate to

the size of the institution and the nature of the institution's activities, and should be consistent with prudent banking practices and relevant regulatory requirements.

Indicators of Troubled Real Estate Markets and Projects, and Related Indebtedness. In order to evaluate the collectibility of an institution's commercial real estate portfolio, examiners should be alert for indicators of weakness in the real estate markets served by the institution. They should also be alert for indicators of actual or potential problems in the individual commercial real estate projects or transactions financed by the institution.

Available indicators, such as permits for — and the value of — new construction, absorption rates, employment trends, and vacancy rates, are useful in evaluating the condition of commercial real estate markets. Weaknesses disclosed by these types of statistics may indicate that a real estate market is experiencing difficulties that may result in cash now problems for individual real estate projects, declining real estate values, and ultimately, in troubled commercial real estate loans.

Indicators of potential or actual difficulties in commercial real estate projects may include:

- An excess of similar projects under construction.

- Construction delays or other unplanned adverse events resulting in cost overruns that may require renegotiation of loan terms.

- Lack of a sound feasibility study or analysis that reflects current and reasonably anticipated market conditions.

- Changes in concept or plan (for example, a condominium project converted to an apartment project because of unfavorable market conditions).

- Rent concessions or sales discounts resulting in cash now below the level projected in the original feasibility study or appraisal.

- Concessions on finishing tenant space, moving expenses, and lease buyouts.

- Slow leasing or lack of sustained sales activity and increasing sales cancellations that may reduce the project's income potential, resulting in protracted repayment or default on the loan.

- Delinquent lease payments from major tenants.

- Land values that assume future rezoning.

- Tax arrearages.

As the problems associated with a commercial real estate project become more pronounced, problems with the related indebtedness may also arise. Such problems include diminished cash flow to service the debt and delinquent interest and principal payments.

While some commercial real estate loans become troubled because of a general downturn in the market, others become troubled because they were originated on an unsound or a liberal basis. Common examples of these types of problems include:

- Loans with no or minimal borrower equity.

- Loans on speculative undeveloped property where the borrowers' only source of repayment is the sale of the property.

- Loans based on land values that have been driven up by rapid turnover of ownership, but without any corresponding improvements to the property or supportable income projections to justify an increase in value.

- Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources.

- Loans to borrowers with no development plans or noncurrent development plans.

- Renewals, extensions and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule.[4]

Examiner Review of Individual Loans, Including the Analysis of Collateral Value. The focus of an examiner's review of a commercial real estate loan, including binding commitments, is the ability of the loan to be repaid. The principal factors that bear on this analysis are the income-producing potential of the

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4. As discussed more fully in the section on classification guidelines, the refinancing or renewing of loans to sound borrowers would not result in a supervisory classification or criticism unless well-defined weaknesses exist that jeopardize repayment of the loans. Consistent with sound banking practices, institutions should work in an appropriate and constructive manner with borrowers who may be experiencing temporary difficulties.

underlying collateral and the borrower's willingness and capacity to repay under the existing loan terms from the borrower's other resources if necessary. In evaluating the overall risk associated with a commercial real estate loan, examiners consider a number of factors, including the character, overall financial condition and resources, and payment record of the borrower; the prospects for support from any financially responsible guarantors; and the nature and degree of protection provided by the cash flow and value of the underlying collateral.[5] However, as other sources of repayment for a troubled commercial real estate loan become inadequate over time, the importance of the collateral's value in the analysis of the loan necessarily increases.

The appraisal regulations of the federal bank and thrift regulatory agencies require institutions to obtain appraisals when certain criteria are met.[6] Management is responsible for reviewing each appraisal's assumptions and conclusions for reasonableness. Appraisal assumptions should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property.[7] Management should adjust any assumptions

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5. The treatment of guarantees in the classification process is discussed in Attachment 1.

6. Department of the Treasure, Office of the Comptroller of the Currency, 12 CFR Part 34 (Docket No. 90-16); Board of Governors of the Federal Reserve System, 12 CFR Parts 208 and 225 (Regulation H and Y; Docket No. R-0685); Federal Deposit Insurance Corporation, 12 CFR 323 (RIN 3064-AB05); Department of the Treasure, Office of Thrift Supervision, 12 CFR Part 564 (Docket No. 90-1495).

7. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions.

used by an appraiser in determining value that are overly optimistic or pessimistic.

An examiner analyzes the collateral's value as determined by the institution's most recent appraisal (or internal evaluation, as applicable). An examiner reviews the major facts, assumptions, and approaches used by the appraiser (including any comments made by management on the value rendered by the appraiser). Under the circumstances described below, the examiner may make adjustments to this assessment of value. This review and any resulting adjustments to value are solely for purposes of an examiner's analysis and classification of a credit and do not involve actual adjustments to an appraisal.

A discounted cash flow analysis is an appropriate method for estimating the value of income-producing real estate collateral.[8] This approach is discussed in more detail in Attachment 2. This analysis should not be based solely on the current performance of the collateral or similar properties; rather, it should take into account, on a discounted basis, the ability of the real estate to generate income over time based upon reasonable and supportable assumptions.

When reviewing the reasonableness of the facts and assumptions associated with the value of the collateral, examiners may evaluate:

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8. The real estate appraisal regulations of the federal bank and thrift regulatory agencies include a requirement that an appraisal (a) follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value; (b) reconcile these approaches; and (c) explain the elimination of each approach not used. A discounted cash flow analysis is recognized as a valuation method for the income approach.

- Current and projected vacancy and absorption rates;
- Lease renewal trends and anticipated rents;
- Volume and trends in past due leases;
- Effective rental rates or sale prices (taking into account all concessions);
- Net operating income of the property as compared with budget projections; and
- Discount rates and direct capitalization ("cap") rates.[9]

The capacity of a property to generate cash flow to service a loan is evaluated based upon rents (or sales), expenses, and rates of occupancy that are reasonably estimated to be achieved over time. The determination of the level of stabilized occupancy and rental rates should be based upon an analysis of current and reasonably expected market conditions, taking into consideration historical levels when appropriate. The analysis of collateral values should not be based upon a simple projection of current levels of net operating income if markets are depressed or reflect speculative pressures but can be expected over a reasonable period of time to return to normal (stabilized) conditions. Judgment is involved in determining the time that it will take for a property to achieve stabilized occupancy and rental rates.

Examiners do not make adjustments to appraisal assumptions for credit analysis purposes based on worst case scenarios that are

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9. Attachment 2 includes a discussion of discount rates and direct capitalization rates.

unlikely to occur. For example, an examiner would not necessarily assume that a building will become vacant just because an existing tenant who is renting at a rate above today's market rate may vacate the property when the current lease expires. On the other hand, an adjustment to value may be appropriate for credit analysis purposes when the valuation assumes renewal at the above-market rate, unless that rate is a reasonable estimate of the expected market rate at the time of renewal.

When estimating the value of income-producing real estate, discount rates and "cap" rates should reflect reasonable expectations about the rate of return that investors require under normal, orderly and sustainable market conditions. Exaggerated, imprudent, or unsustainably high or low discount rates, "cap" rates, and income projections should not be used. Direct capitalization of nonstabilized income flows should also not be used.

Assumptions, when recently made by qualified appraisers (and, as appropriate, by institution management) and when consistent with the discussion above, should be given a reasonable amount of deference. Examiners should not challenge the underlying assumptions, including discount rates and "cap" rates used in appraisals, that differ only in a limited way from norms that would generally be associated with the property under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate and can support alternative assumptions.

Appendix J

Classification Guidelines

As with other types of loans, commercial real estate loans that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or the underlying collateral generally are not classified. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards, including loans to creditworthy commercial or residential real estate developers, should not be classified or criticized unless well-defined weaknesses exist that jeopardize repayment. An institution will not be criticized for continuing to carry loans having weaknesses that result in classification or criticism as long as the institution has a well-conceived and effective workout plan for such borrowers, and effective internal controls to manage the level of these loans.

In evaluating commercial real estate credits for possible classification, examiners apply standard classification definitions (Attachment 3).[10] In determining the appropriate classification, consideration should be given to all important information on repayment prospects, including information on the borrower's creditworthiness, the value of, and cash flow provided by, all collateral supporting the loan, and any support provided by financially responsible guarantors.

The loan's record of performance to date is important and must be taken into consideration. As a general principle, a performing commercial real estate loan should not automatically be classified or charged-off solely because the value of the underlying collateral has declined to an amount that is less than

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10. These definitions are presented in Attachment 3 and addresses assets classified "substandard," "doubtful," or "loss" for supervisory purposes.

the loan balance. However, it would be appropriate to classify a performing loan when well-defined weaknesses exist that jeopardize repayment, such as the lack of credible support for full repayment from reliable sources.[11]

These principles hold for individual credits, even if portions or segments of the industry to which the borrower belongs are experiencing financial difficulties. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectibility of the particular credit. The problems broadly associated with some sectors or segments of an industry, such as certain commercial real estate markets, should not lead to overly pessimistic assessments of particular credits that are not affected by the problems of the troubled sectors.

Classification of troubled project-dependent commercial real estate loans.[12] The following guidelines for classifying a troubled commercial real estate loan apply when the repayment of the debt will be provided solely by the underlying real estate collateral, and there are no other available and reliable sources of repayment.

As a general principle, for a troubled project-dependent

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11. Another issue that arises in the review of a commercial real estate loan is the loan's treatment as an accruing asset or as a nonaccrual asset for reporting purposes. The federal bank and thrift regulatory agencies have provided guidance on nonaccrual status in the instructions for the Reports of Condition and Income (Call Reports) for banks, and in the instructions for the Thrift Financial Report for savings associations, and in related supervisory guidance of the agencies.

12. The discussion in this section is not intended to address loans that must be treated as "other real estate owned" for bank regulatory reporting purposes or "real estate owned" for thrift regulatory reporting purposes. Guidance on these assets is presented in supervisory and reporting guidance of the agencies.

commercial real estate loan, any portion of the loan balance that exceeds the amount that is adequately secured by the value of the collateral, and that can clearly be identified as uncollectible, should be classified "loss."[13] The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified no worse than "substandard." The amount of the loan balance in excess of the value of the collateral, or portions thereof, should be classified "doubtful" when the potential for full loss may be mitigated by the outcomes of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined.

If warranted by the underlying circumstances, an examiner may use a "doubtful" classification on the entire loan balance. However, this would occur infrequently.

Guidelines for classifying partially charged-off loans. Based upon consideration of all relevant factors, an evaluation may indicate that a credit has well-defined weaknesses that jeopardize collection in full, but that a portion of the loan may be reasonably assured of collection. When an institution has taken a charge-off in an amount sufficient that the remaining recorded balance of the loan (a) is being serviced (based upon reliable sources) and (b) is reasonably assured of collection, classification of the remaining recorded balance may not be appropriate. Classification would be appropriate when well-defined weaknesses continue to be present in the remaining recorded balance. In such cases, the remaining recorded balance would generally be classified no more severely than "substandard."

A more severe classification than "substandard" for the

13. For purposes of this discussion, the "value of the collateral" is the value used by the examiner for credit analysis purposes, as discussed in a previous section of this policy statement.

remaining recorded balance would be appropriate if the loss exposure cannot be reasonably determined, e.g., where significant risk exposures are perceived, such as might be the case for bankruptcy situations or for loans collateralized by properties subject to environmental hazards. In addition, classification of the remaining recorded balance would be appropriate when sources of repayment are considered unreliable.

Guidelines for classifying formally restructured loans. The classification treatment previously discussed for a partially charged off loan would also generally be appropriate for a formally restructured loan when partial charge-offs have been taken. For a formally restructured loan, the focus of the examiner's analysis is on the ability of the borrower to repay the loan in accordance with its modified terms. Classification of a formally restructured loan would be appropriate, if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable *modified terms.*[14] Troubled commercial real estate loans whose terms have been restructured should be identified in the institution's internal credit review system, and closely monitored by management.

Review of the Allowance for Loan and Lease Losses (ALLL)[15]

The adequacy of a depository institution's ALLL, including

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14. An example of a restructured commercial real estate loan that does *not* have reasonable modified terms would be a "cash flow" mortgage which requires interest payments *only* when the underlying collateral generates cash flow but provides no substantive benefits to the lending institution.

15. Each of the federal bank and thrift regulatory agencies have issued

(Cont'd)

amounts based on an analysis of the commercial real estate portfolio, must be based on a careful, well documented, and consistently applied analysis of the institution's loan and lease portfolio.[16]

The determination of the adequacy of the ALLL should be based upon management's consideration of all current significant conditions that might affect the ability of borrowers (or guarantors, if any) to fulfill their obligations to the institution. While historical loss experience provides a reasonable starting point, historical losses or even recent trends in losses are not sufficient without further analysis and cannot produce a reliable estimate of anticipated loss.

In determining the adequacy of the ALLL, management should also consider other factors, including changes in the nature and volume of the portfolio; the experience, ability, and depth of lending management and staff; changes in credit standards; collection policies and historical collection experience; concentrations of credit risk; trends in the volume and severity of past due and classified loans; and trends in the volume of nonaccrual loans, specific problem loans and commitments. In

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(Cont'd)
guidance on the allowance for loan and lease losses. The following discussion summarizes general principles for assessing the adequacy of the allowance for loan and lease losses.

16. The estimation process described in this section permits for a more accurate estimate of anticipated losses than could be achieved by assessing the loan portfolio solely on an aggregate basis. However, it is only an estimation process and does not imply that any part of the ALLL is segregated for, or allocated to, any particular asset or group of assets. The ALLL is available to absorb all credit losses originating from the loan and lease portfolio.

addition, this analysis should consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems. Furthermore, management should consider external factors such as local and national economic conditions and developments; competition; and legal and regulatory requirements; as well as reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio.

Management should adequately document the factors that were considered, the methodology and process that were used in determining the adequacy of the ALLL, and the range of possible credit losses estimated by this process. The complexity and scope of this analysis must be appropriate to the size and nature of the institution and provide for sufficient flexibility to accommodate changing circumstances.

Examiners will evaluate the methodology and process that management has followed in arriving at an overall estimate of the ALLL in order to assure that all of the relevant factors affecting the collectibility of the portfolio have been appropriately considered. In addition, the overall estimate of the ALLL and the range of possible credit losses estimated by management will be reviewed for reasonableness in view of these factors. This examiner analysis will also consider the quality of the institution's systems and management in identifying, monitoring, and addressing asset quality problems.

As discussed in the previous section on classification guidelines, the value of the collateral is considered by examiners in reviewing and classifying a commercial real estate loan. However, for a performing commercial real estate loan, the supervisory policies of the agencies do not require automatic

increases to the ALLL solely because the value of the collateral has declined to an amount that is less than the loan balance.

In assessing the ALLL during examinations, it is important to recognize that management's process, methodology, and underlying assumptions require a substantial degree of judgment. Even when an institution maintains sound loan administration and collection procedures and effective internal systems and controls, the estimation of anticipated losses may not be precise due to the wide range of factors that must be considered. Further, the ability to estimate anticipated loss on specific loans and categories of loans improves over time as substantive information accumulates regarding the factors affecting repayment prospects. When management has (a) maintained effective systems and controls for identifying, monitoring and addressing asset quality problems and (b) analyzed all significant factors affecting the collectibility of the portfolio, considerable weight should be given to management's estimates in assessing the adequacy of the ALLL.

Appendix J

Attachment 1

TREATMENT OF GUARANTEES IN THE CLASSIFICATION PROCESS

Initially, the original source of repayment and the borrower's intent and ability to fulfill the obligation without reliance on third party guarantors will be the primary basis for the review and classification of assets.[1] The federal bank and thrift regulatory agencies will, however, consider the support provided by guarantees in the determination of the appropriate classification treatment for troubled loans. The presence of a guarantee from a "financially responsible guarantor," as described below, may be sufficient to preclude classification or reduce the severity of classification.

- For purposes of this discussion, a guarantee from a "financially responsible guarantor" has the following attributes:

- The guarantor must have *both* the financial capacity and willingness to provide support for the credit;

- The nature of the guarantee is such that it can provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term; and[2]

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1. Some loans are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment. In such circumstances, examiners generally assess the collectibility of the loan based upon the guarantor's ability to repay the loan.

2. Some guarantees may only provide for support for certain phases of a real estate project. It would not be appropriate to rely upon these guarantees to support a troubled loan after the completion of these phases.

- The guarantee should be legally enforceable.

The above characteristics generally indicate that a guarantee may improve the prospects for repayment of the debt obligation.

Considerations relating to a guarantor's financial capacity. The lending institution must have sufficient information on the guarantor's financial condition, income, liquidity, cash flow, contingent liabilities, and other relevant factors (including credit ratings, when available) to demonstrate the guarantor's financial capacity to fulfill the obligation. Also, it is important to consider the number and amount of guarantees currently extended by a guarantor, in order to determine that the guarantor has the financial capacity to fulfill the contingent claims that exist.

Considerations relating to a guarantor's willingness to repay. Examiners normally rely on their analysis of the guarantor's financial strength and assume a willingness to perform unless there is evidence to the contrary. This assumption may be modified based on the "track record" of the guarantor, including payments made to date on the asset under review or other obligations.

Examiners give due consideration to those guarantors that have demonstrated their ability and willingness to fulfill previous obligations in their evaluation of current guarantees on similar assets. An important consideration will be whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee. However, examiners give limited credence, if any, to guarantees from obligors who have reneged on obligations in the past, unless there is clear evidence that the guarantor has the ability and intent to honor the specific guarantee obligation under review.

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Examiners also consider the economic incentives for performance from guarantors:

- Who have already partially performed under the guarantee or who have other significant investments in the project;

- Whose other sound projects are cross-collateralized or otherwise intertwined with the credit; or

- Where the guarantees are collateralized by readily marketable assets that are under the control of a third party.

Other considerations. In general, only guarantees that are legally enforceable will be relied upon. However, all legally enforceable guarantees may not be acceptable. In addition to the guarantor's financial capacity and willingness to perform, it is expected that the guarantee will not be subject to significant delays in collection, or undue complexities or uncertainties about the guarantee.

The nature of the guarantee is also considered by examiners. For example, some guarantees for real estate projects only pertain to the development and construction phases of the project. As such, these limited guarantees would not be relied upon to support a troubled loan after the completion of those phases.

Examiners also consider the institution's intent to enforce the guarantee and whether there are valid reasons to preclude an institution from pursuing the guarantee. A history of timely enforcement and successful collection of the full amount of guarantees will be a positive consideration in the classification process.

Appendix J

Attachment 2

THE VALUATION OF INCOME-PRODUCING REAL ESTATE

Approaches to the Valuation of Real Estate

Appraisals are professional judgments of the market value of real property. Three basic valuation approaches are used by professional appraisers in estimating the market value of real property — the cost approach, the market data or direct sales comparison approach, and the income approach. The principles governing the three approaches are widely known in the appraisal field and were recently referenced in parallel regulations issued by each of the federal bank and thrift regulatory agencies. When evaluating the collateral for problem credits, the three valuation approaches are not equally appropriate.

1. **Cost Approach**. In the cost approach, the appraiser estimates the reproduction cost of the building and improvements, deducts estimated depreciation, and adds the value of the land. The cost approach is particularly helpful when reviewing draws on construction loans. However, as the property increases in age, both reproduction cost and depreciation become more difficult to estimate. Except for special purpose facilities, the cost approach is usually inappropriate in a troubled real estate market because construction costs for a new facility normally exceed the market value of existing comparable properties.

2. **Market Data or Direct Sales Comparison Approach.** This approach examines the price of

similar properties that have sold recently in the local market, estimating the value of the subject property based on the comparable properties' selling price. It is very important that the characteristics of the observed transactions be similar in terms of market location, financing terms, property condition and use, timing, and transaction costs. The market approach generally is used in valuing owner-occupied residential property because comparable sales data are typically available. When adequate sales data are available, an analyst generally will give the most weight to this type of estimate. Often, however, the available sales data for commercial properties are not sufficient to justify a conclusion.

3. **The Income Approach.** The economic value of an income-producing property is the discounted value of the future net operating income stream, including any "reversion" value of property when sold. If competitive markets are working perfectly, the observed sales price should be equal to this value. For unique properties or in markets that are thin or subject to disorderly or unusual conditions, market value based on a comparable sales approach may be either unavailable or distorted. In such cases, the income approach is usually the appropriate method for valuing the property.

The income approach converts all expected future net operating income into present value terms. When market conditions are stable and no unusual patterns of future rents and occupancy rates are expected, the direct capitalization method is often used to estimate

the present value of future income streams. For troubled properties, however, examiners typically utilize the more explicit discounted cash flow (net present value) method for analytical purposes. In that method, a time frame for achieving a "stabilized", or normal, occupancy and rent level is projected. Each year's net operating income during that period is discounted to arrive at the present value of expected future cash flows. The property's anticipated sales value at the end of the period until stabilization (its terminal or reversion value) is then estimated. The reversion value represents the capitalization of all future income streams of the property after the projected occupancy level is achieved. The terminal or reversion value is then discounted to its present value and added to the discounted income stream to arrive at the total present market value of the property.

Valuation of Troubled Income-Producing Properties

When an income property is experiencing financial difficulties due to general market conditions or due to its own characteristics, data on comparable property sales often are difficult to obtain. Troubled properties may be hard to market, and normal financing arrangements may not be available. Moreover, forced and liquidation sales can dominate market activity. When the use of comparables is not feasible (which is often the case for commercial properties), the net present value of the most reasonable expectation of the property's income-producing capacity — not just in today's market but over time — offers the most appropriate method of valuation in the supervisory process.

Estimates of the property's value should be based upon

reasonable and supportable projections of the determinants of future net operating income: rents (or sales), expenses and rates of occupancy. Judgment is involved in estimating all of these factors. The primary considerations for these projections include historical levels and trends, the current market performance achieved by the subject and similar properties, and economically feasible and defensible projections of future demand and supply conditions. To the extent that current market activity is dominated by a limited number of transactions or liquidation sales, high "capitalization" and discount rates implied by such transactions should not be used. Rather, analysts should use rates that reflect market conditions that are *neither* highly speculative nor depressed for the type of property being valued and that property's location.

Technical Notes

In the process of reviewing a real estate loan and in the use of the net present value approach of collateral valuation, several conceptual issues often are raised. The following discussion sets forth the meaning and use of those key concepts.

The Discount Rate. The discount rate used in the net present value approach to convert future net cash flows of income-producing real estate into present market value terms is the rate of return that market participants require for this type of real estate investment. The discount rate will vary over time with changes in overall interest rates and in the risk associated with the physical and financial characteristics of the property. The riskiness of the property depends both on the type of real estate in question and on local market conditions.[1]

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1. Regulatory policy of the Office of Thrift Supervision specifies that, for supervisory purposes, thrifts are to use discount rates that are consistent with

(Cont'd)

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The Direct Capitalization ("Cap" Rate) Technique. The use of "cap" rates, or direct income capitalization, is a method used by many market participants and analysts to relate the value of a property to the net operating income it generates. In many applications, a "cap" rate is used as a short cut for computing the discounted value of a property's income streams.

The direct income capitalization method calculates the value of a property by dividing an estimate of its "stabilized" annual income by a factor called a "cap" rate. Stabilized income generally is defined as the yearly net operating income produced by the property at normal occupancy and rental rates; it may be adjusted upward or downward from today's actual market conditions. The "cap" rate — usually defined for each property type in a market area — is viewed by some analysts as the required rate of return stated in terms of current income. That is to say, the "cap" rate can be considered a direct observation of the required earnings-to-price ratio in current income terms. The "cap" rate also can be viewed as the number of cents per dollar of today's purchase price investors would require annually over the life of the property to achieve their required rate of return.

The "cap" rate method is appropriate if the net operating income to which it is applied is representative of all future income streams or if net operating income and the property's selling price are expected to increase at a fixed rate. The use of this technique assumes that either the stabilized income or the "cap" rate used accurately captures all relevant characteristics of the property

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(Cont'd)
generally accepted accounting principles for thrifts (which allow the use of an average-cost-of-capital-funds rate to calculate net realizable value) or discount rates that are consistent with the practices of the federal banking agencies.

relating to its risk and income potential. If the same risk factors, required rate of return, financing arrangements, and income projections are used, explicit discounting and direct capitalization will yield the same results.

This method alone is not appropriate for troubled real estate since income generated by the property is not at normal or stabilized levels. In evaluating troubled real estate, ordinary discounting typically is used for the period before the project reaches its full income potential. A "terminal" "cap" rate is then utilized to estimate the value of the property (its reversion or sales price) at the end of that period.

Differences Between Discount and Cap Rates. When used for estimating real estate market values, discount and "cap" rates should reflect the current market requirements for rates of return on properties of a given type. The discount rate is the required rate of return including the expected increases in future prices and is applied to income streams reflecting inflation. In contrast, the "cap" rate is used in conjunction with a stabilized net operating income figure. The fact that discount rates for real estate are typically higher than "cap" rates reflects the principal difference in the treatment of expected increases in net operating income and/or property values.

Other factors affecting the "cap" rate used (but not the discount rate) include the useful life of the property and financing arrangements. The useful life of the property being evaluated affects the magnitude of the "cap" rate because the income generated by a property, in addition to providing the required return on investment, must be sufficient to compensate the investor for the depreciation of the property over its useful life. The longer the useful life, the smaller is the depreciation in any

one year, hence, the smaller is the annual income required by the investor, and the lower is the "cap" rate. Differences in terms and the extent of debt financing and the related costs must also be taken into account.

Selecting Discount and Cap Rates. The choice of the appropriate values for discount and "cap" rates is a key aspect of income analysis. Both in markets marked by lack of transactions and those characterized by highly speculative or unusually pessimistic attitudes, analysts consider historical required returns on the type of property in question. Where market information is available to determine current required yields, analysts carefully analyze sales prices for differences in financing, special rental arrangements, tenant improvements, property location, and building characteristics. In most local markets, the estimates of discount and "cap" rates used in income analysis should generally fall within a fairly narrow range for comparable properties.

Holding Period vs. Marketing Period. When the income approach is applied to troubled properties, a time frame is chosen over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income). That time period is sometimes referred to as the "holding period." The longer the period before stabilization, the smaller will be the reversion value included in the total value estimate.

The holding period should be distinguished from the concept of "marketing period" a term used in estimating the value of a properly under the sales comparison approach and in discussions of property value when real estate is being sold. The marketing period is the length of time that may be required to sell the property in an open market.

Appendix J

Glossary

Appraisal. A written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

Capitalization rate. A rate used to convert income into value. Specifically, it is the ratio between a property's stabilized net operating income and the property's sales price. Sometimes referred to as an overall rate because it can be computed as a weighted average of component investment claims on net operating income.

Discount rate. A rate of return used to convert future payments or receipts into their present value.

Holding period. The time frame over which a property is expected to achieve stabilized occupancy and rental rates (stabilized income).

Market value. The most probable cash sale price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. buyer and seller are typically motivated (i.e., motivated by self-interest);

2. both parties are well informed or well advised, and acting in what they consider their own best interests;

3. a reasonable time is allowed for exposure in the open market;

4. payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and

5. the price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Marketing period. The term in which an owner of a property is actively attempting to sell that property in a competitive and open market.

Net operating income (NOI). Annual income after all expenses have been deducted, except for depreciation and debt service.

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Attachment 3

Classification Definitions[1]

The federal bank and thrift regulatory agencies currently utilize the following definitions for assets classified "substandard," "doubtful," and "loss" for supervisory purposes:

Substandard Assets. A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Doubtful Assets. An asset classified doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable.

Loss Assets. Assets classified loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has

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1. Office of the Comptroller of the Currency, *Comptroller's Handbook for National Bank Examiners,* Section 215.1, "Classification of Credits;" Board of Governors of the Federal Reserve System, *Commercial Bank Examination Manual,* Section 215.1, "Classification of Credits;" Office of Thrift Supervision, *Thrift Activities Regulatory Handbook,* Section 260, "Classification of Assets;" Federal Deposit Insurance Corporation, *Division of Supervision Manual of Examination Policies,* Section 3.1, "Loans."

absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

APPENDIX K — REGULATORS ISSUE JOINT SUPERVISORY POLICIES, MARCH 1, 1991

OCC • FDIC • FRB • OTS

JOINT AGENCY NEWS RELEASE
Washington, DC

FOR IMMEDIATE RELEASE PR-30-91 (3-1-91)
FIL-8-91

REGULATORS ISSUE JOINT SUPERVISORY POLICIES

The four federal regulators of banks and thrift institutions today issued joint statements and guidelines to clarify certain regulatory and accounting policies. The agencies said the intent of this effort is to contribute to a climate in which banks and thrifts will make loans to credit-worthy borrowers and work constructively with borrowers experiencing financial difficulties, consistent with safe and sound banking practices. The policies encourage increased disclosure about the condition of financial institutions' loan portfolios, facilitate extensions of credit to sound borrowers and the workout of problem loans, and better assure sound assessments of the value of real estate that secures loans.

The four regulatory agencies that issued today's statements are the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), the Federal Reserve Board (FRB), and the Office of Thrift Supervision (OTS). Together, the four agencies supervise the activities of the nation's 12,000 commercial banks and 2,400 thrift institutions.

The joint policy statements cover a wide range of issues, including the following specific points:

Appendix K

- *Recognition of income for certain non-performing loans.* The agencies are considering the merits of proposed guidelines addressing the accrual of income on loans that have been partially charged off. The agencies and the Securities and Exchange Commission will both solicit public comment on the proposed guidelines.

- *Valuation of real estate loans in examinations.* The joint statement clarifies that the supervisory evaluation of real estate loans is based on the ability of the collateral to generate cash flow over time, *not upon its liquidation value.*

- *Guidance on other issues relating to nonaccrual assets and formally restructured debt.* This guidance covers a range of accounting issues, including cash basis income recognition on nonperforming loans, treatment of multiple loans to one borrower, and acquisition of nonaccrual assets.

The four agencies also issued a general statement that stressed the importance of financial institutions working with borrowers who may be experiencing temporary difficulties. The general statement discusses previously released policies that deal with increased disclosure on nonaccrual loans and guidance on the application of the definition of Highly Leveraged Transactions (HLTs). The statement also addressed regulatory policies on capital levels and loan concentrations, as they relate to institutions' ability to make loans to credit-worthy borrowers.

The agencies will send the clarifications and statements to field examiners and depository institutions. The agencies may also issue more detailed guidance on the issues covered in today's

joint statements. Copies of the general statement and the joint policy guidelines released today are available from the OCC, FDIC, FRB, and OTS.

# # # #

Attachment

Distribution: FDIC-Supervised Banks (Commercial and Savings)

Appendix K

OCC • FDIC • FRB • OTS

GENERAL STATEMENT

Recent credit problems have underscored the importance of prudent lending practices to the overall safety and soundness of the nation's financial system. The emergence of credit problems in a number of sectors of the economy has prompted many depository institutions to review their lending practices as well as their capacity to meet credit demands. Many institutions have wisely tightened credit standards where such standards had become too loose. Others have reduced the pace of lending in response to the need to shore up their capital positions and strengthen their balance sheets.

It is possible, however, that some depository institutions may have become overly cautious in their lending practices. In some instances this caution has been attributed to concerns on the part of lenders that the regulators of depository institutions are applying excessively rigorous examination standards.

The Federal banking and thrift regulators do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstanding about them. As a result, the agencies today are issuing a series of guidelines and statements that are intended to clarify regulatory policies in a number of areas and reduce concerns depository institutions may have about extensions of credit to sound borrowers. Specifically, the guidelines and statements released today: (1) encourage enhanced disclosure to the public, (2) facilitate extensions of credit to sound borrowers and the workout of problem loans, and (3) better assure sound assessments of the value of real estate by depository institutions and Federal examiners.

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Recent concerns related to a tightening of credit have focused the agencies' attention on regulatory policies and their effects on institutions' willingness to extend new credit and to work with troubled borrowers. The guidelines and statements released today, which have been under development for some time, are not intended, nor are they expected, to "solve" all credit availability problems. When combined with other steps that have been taken (such as lower money market interest rates and changes in reserve requirements), these initiatives should help facilitate prudent credit extensions to sound borrowers.

Enhanced disclosure will help to ensure that the public is better informed about the nature of institutions' portfolios. The new guidance recently issued by the Office of the Comptroller of the Currency (OCC) on suggested disclosures of more detailed information about nonaccrual loans in public financial statements, and recent banking agency guidelines on Highly Leveraged Transactions, should help by differentiating among broad groups of assets with varying degrees of risk.

Depository institutions have traditionally worked with their borrowers who are experiencing problems. In the current economic environment, it is especially important for institutions to avoid shutting off credit to sound borrowers, especially in sectors of the economy that are experiencing temporary problems.

Consistent with sound banking practices, depository institutions, including those with low capital positions, should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties. Such efforts may include reasonable workout arrangements or prudent steps to restructure extensions of credit. Institutions that have in place

effective internal controls to manage and reduce excessive concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers because of the borrower's particular industry or geographic location.

The documents released today by the Federal bank and thrift regulatory agencies aim to facilitate the workout of problem loans by addressing the income accrual treatment of formally restructured debt and acquired nonaccrual loans consistent with generally accepted accounting principles. Further, there is a clarification of the accounting treatment of multiple loans to a single borrower when some, but not all, of the loans to the borrower are troubled.

The agencies have also clarified when payments may be recognized as income on a cash basis for loans that have been partially charged-off. In addition, the agencies are developing guidelines that address how institutions can accrue income on loans that have been partially charged-off.

Finally, the agencies are also clarifying their policies on the supervisory valuation of real estate. The policies provide that the evaluation of loan loss reserves or net carrying values for real estate loans should reflect a realistic market analysis and not be based solely on liquidation values.

1. *Enhanced Disclosure to the Public*

A. Disclosure of Nonaccrual Loans. Nonaccrual loans vary widely with respect to their quality and cash generating capacity. Consequently, the simple total of such loans on an institution's books may not be a good indicator of the institution's financial position. One method to address this is to provide more

information to the public on these assets. For example, useful supplemental disclosures might include information on the account of charge-offs taken on nonaccrual loans, the amount of cash payments received on these assets, and the portion of these loans that generate substantial cash flow.

OCC recently issued a Banking Bulletin that contains suggestions for the voluntary disclosure of additional information on nonaccrual loans. The Federal regulatory agencies fully support the voluntary disclosures of the type suggested by the OCC and described in the attached statement.

B. Disclosure of Highly Leveraged Transactions. (HLTs) The Federal banking agencies have previously developed a uniform supervisory definition for HLTs. The purpose of the definition is to provide a consistent means to monitor loans to HLT borrowers. The agencies have recently provided the attached additional guidance to examiners and bankers on the application of this definition. This guidance stresses that the HLT designation does not imply a supervisory criticism of the credit.

The guidance also makes clear that certain extensions of credit, such as loans to debtors-in-possession (DIPs), do not fit the definition of HLT loans and should not be so reported. The criteria for the removal of a loan from HLT status have been expanded in the attached document. The agencies will continue to review these criteria to determine if other steps are warranted in view of the characteristics and performance of HLT credits, including the quality and reliability of the borrower's cash flow.

2. *Other Lending Issues*

There appears to be some concern that any new lending by

institutions that fail to meet minimum capital requirements will result in supervisory criticism. While it is essential that depository institutions that fail to meet minimum capital standards take effective and timely steps to address this deficiency, such institutions are not necessarily required to cease prudent, low-risk lending activities. Institutions should attain capital compliance in a prudent manner that strengthens their financial conditions. Institutions that seek to improve their capital-to-assets ratios through shrinking their balance sheets should avoid actions that raise their risk exposure, such as the sale of all high-quality assets or of core deposits. Such actions by themselves, or the refusal to lend to sound borrowers, fail to achieve the important objective of improving the quality of under-capitalized institutions' portfolios.

The agencies share common procedures to address capital deficiencies at depository institutions. In general, each agency requires such institutions to prepare a plan that details the steps they will take to attain the minimum capital levels. Approved plans generally do not preclude a continuation of sound lending activities, including prudent steps to work with borrowers encountering financial difficulties.

Similarly, there appears to be some concern that institutions with loan concentrations are automatically turning down good loans. The benefits of adequate portfolio diversification are well recognized by depository institutions and their regulators. Although the regulatory agencies have not established rigid rules on asset concentrations, they are in agreement that, as a matter of sound operating policy, depository institutions should establish and adhere to policies that control "concentration risk."

Institutions that have in place effective internal controls to

manage and reduce undue concentrations over a reasonable period of time, need not automatically refuse credit to sound borrowers. The purpose of institutions' policies should be to improve the overall quality of their portfolios. The replacement of unsound loans with sound loans can enhance the quality of a depository institution's portfolio, even when concentration levels are not reduced.

3. *Recognition of Income on Certain Nonperforming Loans*

Questions have been raised regarding the recognition of income on loans that have been partially charged-off. This subject is not explicitly addressed in the agencies' regulatory reporting requirements. *The agencies wish to clarify that payments can be recognized as income on a cash basis for loans that have been partially charged-off, without requiring that the prior charge-off first be recovered, so long as the remaining book balance is deemed fully collectible.*

The agencies, along with the Securities and Exchange Commission (SEC), each plan to solicit public comment on proposed guidelines which would allow certain nonperforming loans to be placed back on accrual status once the loans are reduced to an appropriate level through charge-offs. Any formal guidance issued will be based on the comments received from the public and on-going discussions between the agencies and the SEC.

The agencies have released today supervisory guidance on a variety of other issues related to nonaccrual assets and formally restructured debt. These guidelines include a discussion of regulatory requirements related to cash basis income recognition, multiple loans to one borrower, and the acquisition of nonaccrual assets.

Appendix K

4. *Valuation of Real Estate Loans*

In recent months, there have been significant declines in real estate values in certain markets. In response to these declines, examiners have reviewed the adequacy of institutions' loan loss reserves and, where they believed it appropriate, have required additional reserves based on, in part, their estimates of real estate values.

These actions have focused attention on the techniques used to assess the value of real estate, especially commercial real estate. It is important that valuation techniques reflect not only existing market conditions, but also reasonable expectations of the property's performance in the market over time. The Federal regulatory agencies are reiterating their policy on the assessment of real estate values and the establishment of loan loss reserves.

The basic thrust of this guidance is to ensure that income property loans not be assessed solely on the basis of liquidation values but also on the income-producing capacity of the properties over time. Supervisory evaluations should take into account the lack of liquidity and cyclical nature of real estate markets and the temporary imbalances in the supply and demand for real estate that may occur.

5. *Review of Supervisory Findings*

The agencies want to make clear their policy that any institution may request a review of any major decision reached as part of the supervisory process, including those related to asset classification and required reserve levels.

APPENDIX L — UNIFORM AGREEMENT ON THE CLASSIFICATION OF ASSETS AND APPRAISAL OF SECURITIES HELD BY BANKS, JULY, 1991

¶2130.2. Federal Financial Institutions Examination Council Uniform Agreement on the Classification of Assets and Appraisal of Securities Held by Banks.—On April 26, 1991, the Comptroller of the Currency issued BC-127 (Rev.) (which revises BC-127, issued June 8, 1979) to reaffirm the FFIEC's uniform agreement and to clarify the OCC's policy on valuing sub-investment grade securities. *The text of the banking circular and uniform agreement is reproduced below.*—Ed.

To: Chief Executive Officers of All National Banks, Deputy Comptrollers, and all Examining Personnel

PURPOSE

On June 8, 1979, the Comptroller of the Currency issued Banking Circular 127. Banking Circular 127 included a uniform agreement by the Federal Financial Institutions Examination Council (FFIEC) regarding the classification of assets and appraisal of securities held by banks. This revision of Banking Circular 127 reaffirms that uniform statement and clarifies the OCC's policy on valuing sub-investment grade securities.

The FFIEC agreement established guidelines for examiners to follow in distinguishing investment quality from sub-investment quality securities in bank portfolios. Sub-investment quality securities are those with investment characteristics that are distinctly or predominately speculative including securities in rating grades below the four highest grades (e.g. Moody's Ba and below, and Standard and Poor's BB and below) and unrated securities of equivalent quality.

Appendix L

The market value of sub-investment quality securities should be classified substandard. The excess of the carrying value over the market value of sub-investment quality securities should be classified doubtful. Generally accepted accounting principles require an allowance be provided if a market decline is attributable to specific adverse conditions affecting the security. A sub-investment quality rating indicates a specific adverse condition. Accordingly, an allowance attributable to the sub-investment quality security must be provided. The allowance should be at least 50 percent of the amount classified doubtful.

The provisions for an allowance against sub-investment quality securities should be charged to current earnings and reported as securities gains/losses in the Consolidated Reports of Condition and Income. Future declines in value should be provided for in the period the decline occurs. Likewise, if the value subsequently increases, the allowance may be reduced in the period of the increase. The allowance may not be reduced below zero.

If the ultimate collection in full of interest or principal is not expected, the security should be placed on nonaccrual status in accordance with the Instructions to the Consolidated Reports of Condition and Income. In addition, any accrued but uncollected interest on the security should be reversed against current earnings.

Municipal general obligation securities are exempt from the FFIEC's general rules for appraisal and classification. The following rules apply to municipal general obligation securities:

When municipal general obligations are not in default but are regarded as being of sub-investment quality, they are to be classified as substandard assets of the bank.

Appendix L

If a municipal general obligation defaults, the book value of the securities is to be classified doubtful. The doubtful classification will continue until the issuer has taken budgetary, tax or other actions to eliminate the default or until the market for the defaulted securities has stabilized. The regulatory agencies will periodically review the market for the defaulted securities. Upon determination that a functioning market has been reestablished, the depreciation will be classified as loss.

The Uniform Agreement is attached.

UNIFORM AGREEMENT ON THE CLASSIFICATION OF ASSETS AND APPRAISAL OF SECURITIES HELD BY BANKS[1]

Joint Statement of the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Board of Governors of the Federal Reserve System and the Conference of State Bank Supervisors

THE CLASSIFICATION OF ASSETS IN BANK EXAMINATIONS

Classification units are designated as "Substandard," "Doubtful," and "Loss." A Substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected. An asset classified Doubtful has

1. Revises examination procedures established in 1938 and revised July 15, 1949.

all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full, on the basis of currently existing facts, conditions, and values, highly questionable and improbable. Assets classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Fifty percent of the total of "Doubtful" and all of "Loss" will be deducted in computing the net sound capital of the bank. Amounts classified "Loss" should be promptly charged off.

THE APPRAISAL OF SECURITIES IN BANK EXAMINATIONS

Investment quality securities are marketable obligations in which the investment characteristics are not distinctly or predominantly speculative. This group generally includes investment securities in the four highest rating grades and unrated securities of equivalent quality. Neither market appreciation nor depreciation in these securities will be taken into account in figuring net sound capital of the bank. This policy is intended to apply to recognized sound investment practices of banks and not to those situations where the portfolio requires special treatment by a supervisory agency.

Sub-investment quality securities are those in which the investment characteristics are distinctly or predominantly speculative. This group generally includes securities in grades below the four highest grades and unrated securities of

equivalent, quality, defaulted securities and sub-investment quality stocks.

Securities in grades below the four highest rating grades and unrated securities of equivalent value will be valued at market price and the depreciation will be classified Doubtful; remaining book value will be classified Substandard. Depreciation in defaulted securities and sub-investment quality stocks will generally be classified Loss; remaining book value will be classified Substandard.

An exception to the above will be made in the case of municipal general obligations which are backed by the credit and taxing power of the issuer. The entire book value of sub-investment quality municipal general obligations, which are not in default, will be classified Substandard.[2] In the event of a default of a municipal general obligation, a period of time is usually necessary to permit the market for these defaulted securities to stabilize or for the issuer to put in place budgetary, tax or other actions that may eliminate the default, or otherwise improve the post-default value of the securities. The market for the defaulted securities will be periodically reviewed by the regulatory authorities. Upon a determination that a functioning market has been reestablished, depreciation on defaulted municipal general obligations will be classified as Loss. During such interim, the book value of all defaulted municipal general obligation securities will be classified Doubtful.[3]

¶ 21303.3. Federal Reserve Board Policy Statement for Frequency and Scope of Examinations of State Member

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2. and 3. The above exceptions will not apply in those instances where the supervisory authorities determine that there is no likelihood that the municipality will be able ultimately to repay or satisfactorily restructure its obligations.

Appendix L

Banks and Inspections of Bank Holding Companies—Policy for Communicating Problems of Supervisory Concern to Management and Board of Directors.—The Federal Reserve Board announced (10/7/85) two policies to strengthen Reserve Bank supervision of State member banks and bank holding companies. The policies generally increase the frequency of Federal Reserve examinations of State member banks and inspections of bank holding companies, and strengthen the procedures for reporting deficiencies to bank management and boards of directors. The policies were made effective immediately, with initial implementation to commence no later than January 1, 1986.—(Ed.)

Text is as follows: The Board of Governors has approved two new policies for Federal Reserve Banks to follow in supervising state member banks and bank holding companies (see Attachments *A* and *B, infra.*). The *first* sets down guidelines that increase the required frequency of examinations of state member banks and of inspections of bank holding companies, except for certain relatively small bank holding companies. The policy also calls for the Federal Reserve Banks to increase their involvement in examinations/inspections of larger organizations and weaker organizations and to place greater reliance on state banking agencies for the examination/inspection of smaller, healthy organizations, to the extent the states are willing to assume and have the resources to take on these responsibilities.

The *second* policy, designed to formalize and strengthen long-standing practice, provides instructions for communicating the findings of examinations/inspections to the management and boards of directors of organizations with significant problems. The policy requires Reserve bank officials to meet with the management and directors of organizations when an examination

or inspection has revealed that the organization has significant problems. The policy also requires Reserve Banks to provide each member of the board of directors of such organizations with a summary report of the examination/inspection findings. Specifications for the form and general control of these reports are outlined in the policy.

Both policies have common objectives: (a) to help prevent the development of or intensification of problems at banking organizations; and (b) to enhance the effec-

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APPENDIX M — EASING THE CREDIT CRUNCH TO PROMOTE ECONOMIC GROWTH, OCTOBER 8, 1991

TREASURY NEWS

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EASING THE CREDIT CRUNCH TO PROMOTE ECONOMIC GROWTH

Secretary of the Treasury Nicholas Brady today announced new steps in the Administration's ongoing efforts to address "credit crunch" problems identified by the business community, bankers, and regulators. The steps build on the President's economic agenda and are aimed at sustaining the economic recovery.

"Maintaining the economic recovery depends on banks playing their traditional role, businesses making investments, and consumers purchasing goods and services," Brady said. Recent statistics show employment levels, housing starts, and industrial production rising. The Administration wants to insure that proper balance in the regulation of the banking sector continues the upward trend and that Congress passes other Administration economic growth proposals.

The Administration's new steps were developed in consultation with the Federal Reserve Board, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, and the Office of Thrift Supervision. They are designed to promote

confidence and balance in the lending environment, and to help businesses and consumers in their economic activity.

The Administration's program builds on the previous efforts by the Treasury Department and financial regulators to assure that sound businesses and consumers can get needed credit. These efforts include encouraging lenders to make prudent loans and assuring that examiners perform their reviews in a balanced, sensible manner. The federal banking and thrift regulators have stated that they do not want the availability of credit to sound borrowers to be adversely affected by supervisory policies or depository institutions' misunderstandings about them.

In particular, the Administration, while avoiding any encouragement of regulatory laxity, wants to ensure that the specific guidance issued by the regulators over the past several months is being fully implemented by examiners in the field, and that additional opportunities for assuring balanced regulation are pursued. Among the areas addressed are:

— Directives that bankers should work constructively with borrowers experiencing temporary difficulties and facilitate the orderly restructuring of credits;

— Prudent refinancing of economically sound commercial real estate loans;

— Improved verification by regulatory supervisors that recent policy changes and clarifications are appropriately applied in each examination;

— Enhancements in the process for appeals of alleged misapplication of regulatory standards;

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— Harmonization of the treatment of preferred stock in U.S. capital standards with other signatory countries under the Basle capital accord;

— Appropriate application of valuation standards especially in real estate credits so as to avoid a liquidation approach to valuation;

— Improved guidance in the appraisal process and steps to reduce excessive appraisal costs for lenders;

— Legislative action to make permanent recent EPA regulations to limit lender liability for environmental cleanup of loan collateral properties;

This program is in addition to the President's comprehensive economic growth package, which has been stalled in the Congress. These proposals designed for increasing job-creating investment include: reducing the capital gains tax, permanently extending the research and experimentation tax credit, establishing enterprise zones, and promoting saving through Family Savings Accounts and expanded Individual Retirement Accounts. "These proposals should be voted upon without delay," Brady said.

"Congress can also help by passing the Administration's comprehensive banking reform legislation and approving its nominees for top financial regulatory positions which are before the Senate. Holding up these measures and appointments creates further uncertainty about fiscal, monetary, and regulatory policies," Brady said.

Details of the Administration program are found on the attached fact sheet.

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EASING THE CREDIT CRUNCH TO HELP PROMOTE ECONOMIC GROWTH

FACT SHEET

I. NEW REGULATORY ACTIONS TO BE IMPLEMENTED

A. Efforts to Improve Lending Environment

Conform U. S. Implementation of Basle Capital Standards

Conform U. S. treatment of Preferred Stock in Tier One capital with other countries under the Basle accord. No amendment to the Basle capital standards is needed.

Removing this ceiling will give bank holding companies an additional method of raising Tier One capital, as there are investors who prefer preferred stock to common shares.

This could result in an increase in Tier One capital and thus expand lending capacity.

The target date for completing this conforming change is October 31, 1991.

B. Build Banker Confidence

1. Enhanced Examination Appeals Process

Each agency has an existing appeals process for bankers who believe that examiners have made an error in their evaluation of loans. Although the guidelines issued March

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1st encouraged bankers to take advantage of this mechanism, few bankers have done so.

Thus, it is recommended that the appeals process be strengthened by allowing a banker to appeal directly to senior officials or a Reserve Bank President separate from the supervisory process. Investigations would be conducted in a confidential manner.

Each regulatory agency will implement this system by November 15, 1991.

2. Improve Examination Management

In order to further assure that consistent and balanced examination standards are applied, agencies will take the following steps:

a. Regional supervisory management will be required to:

i) make sure that the March 1st policychanges and clarifications, and all subsequent guidelines, have been effectively communicated to each examiner;

ii) make sure that these policy changes and guidelines have been explained to the banker by the examiner in each examination; and

iii) certify that these policy changes and clarifications, and all subsequent guidance, have been followed by examiners in each exam.

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These policy changes and clarifications include the instruction that:

- bankers should work in an appropriate and constructive fashion with borrowers who may be experiencing temporary difficulties;

- income producing property loans are to be assessed on the income-producing capacity of the properties over time. Examiners should take into account the lack of liquidity and cyclical nature of real estate markets. Liquidation appraisal values are to be used only if the property is to be liquidated;

- banks with real estate concentrations should not automatically refuse new credit to sound real estate developers or to work with existing borrowers;

- regulatory agencies do *not* have rigid rules (or percentages) on asset concentrations, as bankers and regulators know well the benefits of adequate portfolio diversification;

- institutions attempting to raise capital by shrinking assets should avoid actions such as the sale of all high-quality assets. Such actions by themselves, or the refusal to make sound, new loans, fail to achieve an important goal of improving the quality of the institution's loan portfolio;

- bankers and examiners should not lump all real estate together: distinctions should be made. For example,

credit for a residential builder, should not be automatically penalized by local oversupply conditions in commercial office development;

- bankers should facilitate the orderly restructuring of troubled credits by using established techniques under FASB 15, "Troubled Debt Restructuring"; and

- banks should be able to prudently refinance commercial real estate loans without fear of regulatory retribution ("mini-perm" guidance).

b. The agencies will develop a method for regular communication with bankers by central office and/or regional senior personnel to determine banker views on the fairness and balance of examination standards and practices. Examples of this communication would include polling and regular meetings with bankers.

The agencies will implement these changes by November 15, 1991 .

C. Improve Real Estate Guidance

1. Real Estate Valuation Policies

The bank and thrift regulatory agencies have been developing a uniform and comprehensive set of real estate examination guidelines, especially for real estate in troubled markets. These detailed guidelines cover loan classification procedures, indicators of troubled loans, proper analysis of appraisals and loan values, and proper reserve analysis.

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These guidelines will be released by October 31, 1991 and will be distributed to all examiners — and bankers.

2. Use of Appraisals

As a part of Subsection 1 above, a letter will be sent by the primary regulator to every bank chief executive outlining the guidelines for using appraisal emphasizing balance and appropriate time lines.

3. Random Audit Program

The regulatory agencies would establish quality control through a random audit program to determine how examiners are using appraisals in the loan documentation process.

This can be implemented by October 31, 1991.

4. Appraisal Costs

The Administration supports the actions taken recently by the regulatory agencies to limit the costs of appraisals on residential real estate loans by raising the minimum loan size subject to appraisal requirements to $100,000 from $50.000. The Administration calls on the regulatory agencies to consider additional steps that can be taken administratively to lower the burden of appraisal costs, especially for home buyers and small business.

The agencies will report their recommendations to the Secretary of the Treasury by January 1, 1992.

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D. Further Clarify the Definition of Highly Leveraged Transaction (HLT)

Leveraged borrowers in businesses such as cable television or broadcast media have cited the HLT definition as unreasonably restraining credit to their industries.

The agencies published their definition for public comment in the *Federal Register.* The comment period concluded on September 23, 1991, resulting in over 200 comment letters.

The regulatory agencies will review the comments and propose improvements to the definition by December 1, 1991.

E. Convene National Meeting of Examiners

The Treasury Secretary has requested that by mid-November, 1991, the regulatory agencies convene a meeting of all key supervisory management and senior field examination professionals.

Examiners would participate in a series of meetings about the economy and a thorough briefing on the policy changes and guidelines and their application.

II. PROPOSALS THAT WOULD HELP CURE THE CREDIT CRUNCH WHICH REQUIRE ACTION BY CONGRESS

The Administration supports a number of legislative proposals that would promote savings and economic growth, make the financial sector more efficient and create a better climate for lending. These include:

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A. Banking Reform

The President's Banking Reform bill will spur confidence for investment by assuring that the United States has a modern banking system with stronger, safer banks.

Stronger, more competitive banks would have greater flexibility in working with borrowers to avoid future credit crunches.

B. Lender Liability Reform

Banks have been reluctant to make certain loans because of recent court cases that have found lenders liable for environmental clean-up costs, even when the bank's only interest in a property is a security interest to secure a loan.

To address this uncertainty concern, the EPA issued a proposed regulation interpreting the Superfund Act which would properly limit lenders' liability for any Superfund clean-up costs as long their participation is merely that of a lender, and not a long term operator.

To make this certainty permanent, the Administration is supportive of efforts to further clarify these rule changes in statute.

C. The President's Growth Initiatives

To increase demand and boost asset values, including real estate, the Administration continues to urge Congress to pass the President's growth package. The program would:

- reduce the capital gains tax rate;
- enhance personal savings through an expanded Individual Retirement Account (IRA) and Family Savings Account;
- make the Research and Experimentation (R&E) tax credit permanent;
- increase federal investment in science, technology and infrastructure;
- reform the education system; and
- keep the discipline of the budget agreement.

D. Nominees for Regulatory Positions

Three out of four bank and thrift regulatory agencies are without a Senate-confirmed head. Presidential nominees for regulatory positions awaiting Senate confirmation, include two members and the Chairman of the Federal Reserve Board, as well as the Comptroller of the Currency and the Chairman of the FDIC.

The Administration urges Congress to eliminate uncertainty about the direction of monetary policy and regulatory leadership by acting quickly to confirm the President's nominees. Congress' preoccupation with second guessing regulators has continued to exacerbate the credit crunch.

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E. Bankruptcy Reform

Some in Congress and the American Bankers Association point out that recent court decisions, a developing social acceptability of bankruptcy, and aggressive tactics by borrowers have weakened bankruptcy practices and thus, reduced the willingness of bankers to lend.

The Justice Department has recently undertaken a comprehensive review of the bankruptcy law and practice. The President has asked the Acting Attorney General to complete this review, analyze pending legislative initiatives, and, together with the Secretary of the Treasury, evaluate their impact on credit extensions by financial institutions.

This report will be made to the Economic Policy Council in January 1992.

The Economic Policy Council and the regulatory agencies will continue to review the credit crunch and related issues.

APPENDIX N — HONORABLE JOHN E. ROBSON, DEPUTY SECRETARY OF THE TREASURY, BEFORE THE COMMITTEE ON SMALL BUSINESS, UNITED STATES SENATE, OCTOBER 30, 1991

TREASURY NEWS

Department of the Treasury • Washington, D.C. •
Telephone 566-204_

Embargoed Until Release
October 30, 1991
9:00 am

The Honorable John Robson
Deputy Secretary of the Treasury
Before the Committee on Small Business
United States Senate

October 30, 1991

Mr. Chairman, members of the Committee, I am pleased to appear before you today to address issues relating to the availability of bank credit.

Today, I would like to describe the steps the Administration has taken, with the collaboration and cooperation of the bank and thrift regulatory agencies — the Federal Reserve Board, the FDIC, the Comptroller of the Currency and the Office of Thrift Supervision, to address the regulatory aspects of this credit crunch. Also, I would like to discuss how the passage of the President's growth initiatives and comprehensive banking reform could contribute to a healthier economy and stronger, more competitive banks which can better handle future periods of tight credit.

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Factors Contributing to the Credit Crunch

During the last year there has been considerable discussion about the so-called "credit crunch" and its impact on the economy.

Let me say first, that despite some assertions in the media that the credit crunch is illusory, we believe that a real credit crunch exists for certain types of borrowers and in certain regions of the country and that it is having a negative effect on the economic recovery. By "credit crunch" I mean that loans which could reasonably and responsibly be made are not available. These are loans that in normal times would be made — not go-go credits — and loans which could be extended under traditional standards. A banker in a recent meeting we had put it succinctly when he said, "We are not making loans that we could make". So we do not concur in the thesis that the current credit situation is simply a matter of weak demand for loans. This problem has a supply side.

The credit crunch has multiple causes which I will discuss in more detail, but which I will enumerate on here to indicate its complexity. These causes include:

— The recession, which has sapped consumer, business and banker confidence;

— Lender caution induced by the savings and loan catastrophe;

— Lenders' effort to build capital to mee international standards and satisfy stock market and credit agency concern about financial institution capital levels;

— Severe overbuilding in the real estate sector, especially commercial real estate;

— Reduced lending and tougher collateral requirements caused by the perception that borrowers have easier access to bankruptcy protection;

— Bank management uncertainty about what future structure and laws will govern the industry;

— Increased risk aversity, due to greater exposure to liability on the part of bank directors and officers and various professionals such as appraisers and accountants; and

— The influence of bank regulatory policy and examiner overreaction.

Let me also add that we are, as is the Committee, aware of the severe consequences a credit crunch has on small and medium businesses which do not have access to the capital markets and must rely primarily on bank credit for growth, expansion, and in some cases, survival.

Recession

From roughly July of 1990 until mid-year 1991, our country experienced a recession — a recession somewhat less severe than average, but a very real one nevertheless. This declining level of economic activity, combined with the uncertainty resulting from fighting in the Persian Gulf War, negatively impacted consumer and business confidence. During recessions, people buy less, so demands for credit soften. Likewise, real estate markets have experienced increasing vacancy rates and falling rents. Commercial banks have seen a rise in non-performing assets and

the need for greater loan loss reserves — while at the same time they are working to raise capital.

Recognizing these trends, the Federal Reserve Board lowered short-term interest rates and reduced the reserves that banks are required to maintain on deposit at the Federal Reserve. While these steps were helpful, it is my view that the Federal Reserve actions came too slowly. Money supply, as measured by M2, is still growing well below the rate set by the Federal Reserve's own target ranges.

The Commerce Department reported yesterday that real GNP rose at an annual rate of 2.4 percent in the third quarter, so that while not robust, the economy has moved out of recession. These are macroeconomic statistics and we realize that there are regions and economic sectors which are struggling.

Regulations Impact on the Supply of Credit

Many businesses and borrowers have reported a significantly more stringent bank regulatory approach. It must be said first that this approach was in substantial measure due to the banking agencies' application of prudent regulation in more severe economic conditions, where the creditworthiness of borrowers and the values of collateral had in fact deteriorated, necessitating larger loan loss reserves. Praise, not criticism, should be given to the bank regulators for vigilance in difficult economic conditions. No one wants to return to the dangerous regulatory laxity that marked the savings and loan collapse.

However, it is this same savings and loan collapse that many believe has generated an overcorrection — or some would call overzealousness — in the application of regulatory policy.

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Nearly every day, an examiner can turn on CSPAN or read in the local newspaper about a Congressional Committee attacking a regulator for being too lax — rarely, if ever, for being too strict. Thus, the nearly 7,000 examiners in the field are subjected to a "mixed message." This mixed message makes the job of achieving our goal — balanced, common sense regulation — especially difficult. This hearing is an important step in examining how to achieve a more direct and balanced message from both the legislative and the executive branches of government.

Likewise, prompt confirmation of Bob Clarke and Alan Greenspan, as well as the President's nominees to the Board of Governors of the Federal Reserve, would reduce uncertainty about the direction of regulatory policy.

There are banks, borrowers, and economic sectors experiencing temporary difficulties which need flexibility to work through their problems, and, regulatory judgment should and can be quite responsibly exercised in these situations.

In these areas of appropriate regulatory judgment the perception has been created among banks and businesses that examiners are inflexible and overly harsh. This perception has contributed to create an atmosphere of risk-aversity, apprehension and hesitation among lenders, and has resulted in the constraint of bank credit even to sound borrowers.

Lenders Contribution to the Credit Crunch

Bankers too have become more cautious. This is due in part to the perceived increase in regulatory scrutiny. But, bankers have on their own, tightened loan standards in response to their

bad experiences with the loan loss lessons of the last decade: farm credit, third world debt, real estate, and highly leveraged transactions. These previous difficulties have increased the risk aversity of many loan officers.

It is also reported to us that bank directors, concerned about increased personal liability due to the provisions contained in FIRREA and the 1990 Crime Control Act, have instructed officers to be ultra-conservative in their lending. Wall Street stock analysts consider real estate "high risk lending" and thus, publicly traded banking companies are attempting to please analysts and boost their stock prices by rapidly reducing their real estate exposure. Banks hurt by loan losses in real estate may limit new lending to even credit worthy small businesses, as they attempt to shrink loan portfolios in order to build capital reserves.

The result is a banking system that is not functioning properly and that has retreated from its role as a taker of reasonable risks to fuel the establishment of new enterprises and the expansion of economic activity. It is my opinion that it is a poorer America where the old fashioned character loan is no longer available.

The Credit Crunch and Small Business

The impact of this credit crunch on small business, like the rest of the country, has not been uniform. New England continues to report more problems than elsewhere.

The National Federation of Independent Business (NFIB) quarterly publishes a survey of 2,000 small businesses. In both the March and July 1991 surveys, those small businesses who regularly borrow did not cite a material difficulty in obtaining

credit. The study did note that there was a weak demand for short-term loans, particularly in light of earnings performance.

Credit availability for small business in the second quarter was unchanged from what it has been over the last year. However, borrowing frequency held at comparatively low levels and we continue to hear anecdotal evidence of small business not getting credit. One percent of those polled by the NFIB reported credit easier to obtain in the last three months compared to the prior three; 12 percent reported it harder to get. These numbers indicated that credit has been more difficult to obtain in the last quarter than it has been historically, but not more so than in the three prior recessions.

One area we have followed closely is residential housing. Many single family home builders have pointed to a dramatic decrease in credit available for new construction — even in areas where there is identifiable demand for new starts. These borrowers could be victims of both overly cautious bankers and regulators, and also of a failure to distinguish properly among credit requests for commercial real estate in overbuilt markets and needed residential real estate credit. Another area of difficulty are those small businesses attempting to borrow and operate in regions of the country where there have been a large number of local banks in financial difficulty, such as New England or here in the Washington, D.C. metropolitan area.

Improving the Climate for Lending

Since the summer of 1990, President Bush and other Administration officials have been meeting with bankers, businesses, and the regulators to identify specific steps that could be taken to improve the climate for lending. These meetings led to

regulatory policy changes and clarifications that were released in March, July, and October of 1991. Each of these steps is aimed at achieving balance and common sense in the application of regulatory policy, and raising the level of confidence in the lending environment. These changes are permanent changes to improve bank regulation. They are not simply quick-fix changes which will be abandoned when the credit crunch is over.

Some of these policy changes provided specific guidelines for the handling of troubled real estate loans, methods for working with troubled borrowers and improving the banker-examiner relationship. Specific changes and clarifications include:

— Directives that bankers should work constructively with borrowers experiencing temporary difficulties and facilitate the orderly restructuring of credits;

— Prudent refinancing of economically sound commercial real estate loans;

— Improved verification by regulatory supervisors that recent policy changes and clarifications are appropriately applied in each examination;

— Enhancements in the process for appeals of alleged misapplication of regulatory standards;

— Harmonization of the treatment of preferred stock in U.S. capital standards with other signatory countries under the Basle capital accord;

— Appropriate application of valuation standards especially in real estate credits so as to avoid a liquidation approach to valuation;

— Improved guidance in the appraisal process and steps to reduce excessive appraisal costs for lenders; and

— Legislative action to make permanent a recent EPA proposed regulation to limit lender liability for environmental cleanup of loan collateral properties, and to address related issues.

Long-Term Solutions to Future Credit Crunches

Addressing the credit crunch is a battle which must be waged in the short term to accelerate and sustain the economic recovery. To encourage long term economic growth, Congress should act immediately to pass the President's initiatives for economic growth which were submitted in our 1992 budget request but on which Congress had yet to act. Our program would:

— Reduce the capital gains tax rate to promote jobs and business formation;

— Enhance personal savings through an expanded Individual Retirement Account (IRA) and the Family Savings Account

— Make permanent the Research and Experimentation tax credit;

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— Increase federal investment in science, technology and infrastructure;

— And keep the pay-as-you-go system in the budget process to ensure that any new spending must be offset by decreased spending elsewhere in the budget. This restraint on federal spending must be kept in place to contain the deficit.

Next, in order to ensure that our country has a competitive and strong financial services industry, the Congress should pass the President's comprehensive banking reform measures. As Treasury Secretary Brady said on March 18, 1991, "the state of banking in the U.S. leaves taxpayers overexposed, consumers and business underserved, and the industry increasingly uncompetitive.

Comprehensive reform is essential because strong banks and financial service firms are a key to the economic health of our country. Strong banks will keep credit available in good times and bad, fueling economic growth and new jobs. Competitive, well capitalized financial institutions are a sure way to avoid future credit crunches. If you want stronger banks, banks that will return to the business of lending money to sound customers for sound projects, work with your colleagues to pass this package.

Conclusion

Mr. Chairman, in the past, I have served as the head of a federal regulatory agency and as the chief executive officer of a company operating in a regulated industry. Thus, I believe that I can speak with some perspective on the dynamics of the regulatory process and what it takes to achieve the desired result.

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It takes constant and consistent communication of the policies and procedures that one wants followed in order to achieve balanced and consistent regulation. Regulation should be consistent in boom times as well as times of economic hardship. We need the help of you and your colleagues, Mr. Chairman, to accomplish our mutual goal of safe and sound banks and available credit for America's entrepreneurs and businesses.

I would now be pleased to respond to the Committee's questions.

APPENDIX O — OTHER REAL ESTATE AND REAL ESTATE SALES CONTRACTS, MEP, P.3.5-1

OTHER REAL ESTATE AND REAL ESTATE SALES CONTRACTS

I. OTHER REAL ESTATE

For examination and reporting purposes, other real estate consists of all real estate, other than bank premises, actually owned by the bank and its consolidated subsidiaries. Most states have laws restricting both the acquisition and retention of such assets. In identifying assets which indirectly represent other real estate, examiners should look to substance rather than the form in which the property is held. For the most part, banks, find themselves with effective possession and/or title to other real estate as the result of foreclosure on defaulted mortgage loans, or in partial or total satisfaction of other types of loans.

Book and Takeover Value

In most instances, book value of other real estate coincides with acquisition or takeover values. With respect to real estate acquired through default of a loan, aggregate cost should include the unpaid balance of the defaulted loan plus any completion and holding costs, such as real estate taxes, maintenance and insurance. Legal fees and other direct costs incurred by the bank in a foreclosure should be included in expenses when they are incurred.

In purchasing, foreclosing, or otherwise acquiring property, banks ordinarily take it subject to existing prior liens, as distinct from assuming such liens. For instance, if a bank forecloses on a second mortgage and takes the property subject to a lien, the party owning such lien has legal recourse to the property itself and to

the maker of the lien, but not against the bank as such. It is only when the bank assumes the lien that it becomes directly liable, and in such instances the book or takeover value of the property is increased by a like amount.

There are three major phases of the other real estate owned life cycle: acquisition, holding period and disposition. The acquisition of other real estate owned is specifically addressed in FASB 15, "Accounting by Debtors and Creditors for Troubled Debt Restructurings." The treatment of holding period costs is covered by basic accounting conventions and, to a lesser extent, by FASB 34, "Capitalization of Interest Cost," and FASB 67, "Accounting for Costs and Initial Rental Operations of Real Estate Projects." The disposition of other real estate is addressed in FASB 66, "Accounting for Sales of Real Estate," which sets forth specific criteria for the recognition of profit.

Appraisal and Classification

Banks should make periodic reappraisals of other real estate. Examiners can test the general validity of appraised values by comparing sale prices and appraised values of properties previously held. The fact of foreclosure is presumptive but not conclusive evidence that takeover value exceeds market or appraised value. Each parcel of other real estate is to be reviewed and classified on its own merits. In making that judgment, the examiner will find it necessary to:

1. Ascertain the reason for the acquisition of the property and the bank's intentions as to its disposition;

2 Analyze its carrying value in relation to

appraised value, the bank's "asking" price, and offers received;

3. Determine the length of time the property has been held and the reason(s) it has not yet been sold; and

4. Review other pertinent factors, including title, statutory redemption privileges, other liens, tax status, insurance, present occupancy, rentals, expenses, etc.

Any portion of carrying value in excess of appraised value should be classified Loss. Often a reliable appraisal may not be available or the appraisal on file may be suspect for various reasons. Nevertheless, a careful evaluation of all the relevant factors, many of which have been alluded to above, should enable the examiner to make an accurate and reliable judgment with regard to classification.

II. REAL ESTATE SALES CONTRACTS

The term "real estate sales contract" includes all instruments representing the sale of real estate, other than purchase-money mortgages and trust deeds. Other terms sometimes used to describe such instruments are Land Contract, Bond for Title, Bond for Deed, Earnest Money Contracts, and Instalment Contracts. Under these contracts, title to the property ordinarily remains vested in the seller until all or a certain percentage of the purchase price is paid, at which time a mortgage is taken and/or a deed is delivered. Such contracts were developed to facilitate the disposal of other real estate, and in some areas are used in lieu of the normal mortgage instrument or trust deed.

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Significance and Characteristics

Banks have found that a well-made contract can be a practical and workable instrument for the elimination of other real estate. It provides a means by which the bank can be relieved of a non-earning asset, at least to the extent that interest is received (see discussion concerning troubled debt restructuring in the Loans Section of this Manual), and the bank is no longer obligated to assume such expenses as taxes, insurance, repairs, assessments or similar charges. The device has also apparently added to the marketability of some properties. In some situations, however, contracts are more undesirable than other real estate itself. For example, where a contract involves a little or no down payment and reduction payments are no greater than might reasonably be expected if property were rented, the bank is prevented form taking advantage or more favorable opportunities that might arise. This last situation is compounded the longer the repayment period of the contract.

Appraisal and Classification

Contracts should not be adversely classified if, in the opinion of the examiner, a contract represents a true and bona fide sale, the present equity of the purchaser is satisfactory, the purchaser is responsible, and default is not present or imminent.

II. ACCOUNTING AND REPORT TREATMENT FOR DEBT RESTRUCTURING

Generally accepted accounting principles require that "economic value" and present value calculations be used when restructuring certain troubled debts. This requirement is detailed in Statement

of Financial Accounting Standards No. 15 (FASB 15) and Accounting Principles Board Opinion No. 21 (APBO 21) and can, depending on the facts and circumstances, be applicable to a bank's foreclosure on real estate and subsequent resale of the property at concessionary terms.

Failure to account for the disposition of other real estate in accordance with the provisions of FASB 15 and APBO 21 may result in an understatement of the amount of loss a bank should report in conjunction with a transaction. Examiners therefore need to be alert to this possibility and have a working knowledge of the proper accounting treatment involved. Troubled debt restructuring is covered in greater detail in the Loans Section of this Manual.

APPENDIX P — REAL ESTATE LOANS — APPRAISALS, 12 CFR PART 323, AUGUST 20, 1990

REAL ESTATE LOANS

[¶ 88,224] FDIC Adopts Real Estate Appraisal Standard.

Federal Deposit Insurance Corporation. 55 *Federal Register* 33879, August 20, 1990. Notice in full text.

Real Estate Loans—Appraisals—FDIC Regulations.— The Federal Deposit Insurance Corporation has adopted regulations regarding the performance and utilization of appraisals in connection with federally related transaction under its jurisdiction. Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 required the FDIC adopt the appraisal standards. Title XI and the newly-adopted regulations are intended to protect federal financial and public policy interests in real estate-related transactions requiring the services of an appraiser. The regulations become effective September 19, 1990.

Back reference: ¶ 66,019.

[*FDIC Notice*]

Federal Deposit Insurance Corporation

12 CFR Part 323

RIN 3064-AB05

Appraisals

AGENCY: Federal Deposit Insurance Corporation (FDIC).

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ACTION: Final rule.

SUMMARY: Title XI of the Federal Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")[1] requires the FDIC to adopt regulations regarding the performance and utilization of appraisals in connection with federally related transactions under its jurisdiction. Title XI and these implementing regulations are intended to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. This regulation, and similar regulations adopted by the other financial institutions regulatory agencies[2] and the Resolution Trust Corporation ("RTC") provide affected parties with added assurance that real estate appraisals used in connection with federally related transactions are performed in accordance with uniform standards by individuals whose compentency has been demonstrated and whose professional conduct will be subject to effective supervision. Toward this end, the regulation identifies which transactions require an appraiser, sets forth minimum standards for performing appraisals, and distinguishes those appraisers requiring the services of a State certified appraiser from those requiring a State licensed appraiser.

DATES: *Effective Date:* The effective date of this regulation is September 19, 1990.

Compliance Dates: Appraisals performed in connection with federally related transactions are to comply with the

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1. Public Law No. 101-73, 103 Stat. 183 (1989); 12 U.S.C. 3310, 3331-3351.

2. The Board of Governors of the Federal Reserve System ("FRB"), the Office of the Comptroller of the Currency ("OCC") the Office of Thrift Supervision ("OTS"), and the National Credit Union Administration ("NCUA").

standards of this regulation on its effective date, but § 323.3(b) and (c) must be complied with by July 1, 1991 or such later date as may be established pursuant to section 1119 of FIRREA (12 U.S.C. 3348). Appraisals for real estate-related financial transactions entered into before the regulation's effective date do not have to comply with the standards of this regulation; moreover, sales of loans that were originated before such effective date will not require an appraisal to be performed in accordance with this regulation. A transaction will be deemed originated if there is a binding commitment to perform before the effective date of this regulation.

FOR FURTHER INFORMATION CONTACT: (For information on supervisory issues) Robert F. Miailovich, Assistant Director, (202) 898-6918, or James D. Leitner, Examination Specialist, Division of Supervision, (202) 898-6790; (for information on liquidation issues) N. Jack Taylor, Senior Liquidation Specialist, Division of Liquidation, (202) 898-7326; (for information on legal issues) Walter P. Doyle, Counsel, Legal Division (202) 898-3682; FDIC, 550 17th Street N.W., Washington, DC 20429.

SUPPLEMENTAL INFORMATION:

A. Background

Title XI of FIRREA requires the FDIC to establish standards for performing appraisals in connection with federally related transactions within its jurisdiction. In addition, title XI requires the FDIC to identify those circumstances that require a State certified appraiser and those that require a State certified or licensed appraiser. In response to this legislative mandate, the FDIC has adopted this regulation which is designed to address problems perceived by Congress and the FDIC.

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Section 1121 of FIRREA defines a "federally related transaction" as a real estate-related financial transaction which, *inter alia,* requires the services of an appraiser. the FDIC has required State certified or licensed appraisers to be used for all real estate-related financial transactions except those transactions in which (i) A lien is placed on real property solely through an abundance of caution, (ii) the transaction value (as defined in the regulation) is less than or equal to $50,000, (iii) the transaction involves a lease that is not the economic equivalent of a purchase or sale, (iv) the renewal of an extension or credit under certain circumstances, and (v) the acquisition of interests in loans or mortgage-backed securities if the loans complied with this regulation when originated. The FDIC, acting pursuant to section 1112 of FIRREA, has identified which categories of federally related transactions will require a State certified appraiser and which will require a State licensed appraiser.

In addition, the FDIC has adopted standards, pursuant to section 1110 of FIRREA, for the performance of appraisals in connection with federally related transactions within its jurisdiction. As mandated by title XI, these standards require that all such appraisals be written and that they conform to the Uniform Standards of Professional Appraisal Practice ("USPAP") promulgated by the Appraisal Standards Board of the Appraisal Foundation.[3] Further, the FDIC has adopted additional standards set forth in this regulation.

This regulation is intended to supplement the FDIC's

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3. The appraisal Foundation was established by several professional organizations as a not-for-profit corporation under the laws of Illinois in order to enhance the quality of professional appraisals.

supervisory appraisal guidelines[4] currently in effect. These guidelines will remain in effect subject to amendment.

The FDIC has adopted this regulation to improve the safety and soundness all financial institutions covered by title XI within its jurisdiction. The soundness of real estate loans and investments made by financial institutions covered by title XI depends upon the adequacy of the underwriting or analysis used to support these transactions. A real estate appraisal is one of several essential components of the lending process. Accordingly, through the integration of existing guidance on real estate appraisals with the additional requirements imposed by title XI, this regulation is intended to provide the affected entities with a reasonable degree of assurance that real estate appraisals used in connection with federally related transactions will be reliable.

As indicated above, title XI mandates that these standards require compliance with generally accepted appraisal practices as evidenced by the USPAP. The FDIC is awaiting final revisions to relevant provisions of the USPAP which are being prepared by the Appraisal Standards Board. Upon receipt of these changes, the FDIC intends to solicit comments on the revised USPAP in order to collect the broadest possible comment regarding appraisal standards for federally related transactions, including those in the USPAP. Upon receipt of those comments, the FDIC thereafter may propose amendments to this regulation, should it be deemed appropriate.

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4. *See Guidelines for Real Estate Appraisal Policies and Review Procedures, adopted* by the various divisions of bank supervision at the FDIC, the OCC and the FRB.

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B. Summary of Comments

On February 22, 1990 (55 FR 6266) the FDIC issued for comment proposed rules to implement title XI of FIRREA. The FDIC received 313 letters from individuals and organizations. The principal issues raised by the comments are discussed below. In addition, the section-by-section analysis in Section C addresses many of the concerns raised by the comments.

Section 323.1 Authority, Purpose, and Scope

Several commenters believed that title XI of FIRREA does not authorize the FDIC to promulgate certain provisions of the regulation including the authority to prohibit a regulated institution from selecting an appraiser solely on the basis of membership in an appraisal organization. The FDIC believes that this provision is consistent with both the letter and the spirit of title XI. Moreover, the FDIC believes that the safety and soundness of regulated institutions is advanced by this provision. To provide an additional basis for this and other requirements, the section has been amended to include a citation to the provisions that grant to the FDIC board enforcement and regulatory authority.

Section 323.2 Definitions

The FDIC received comments on the following definitions.

Appraisal. Commenters noted that the regulation did not distinguish between the process of developing an opinion of market value, that is an "appraisal", and the written document itself, which is the "appraisal report." The FDIC will retain the definition unchanged because it more closely follows the

statutory language in title XI and is a term widely used by banks, government agencies and others.

Complex 1-to-4 family residential property appraisal. One-seventh of the comment letters expressed various opinions concerning the use of the term "complex". Some commenters stated that the proposed definition was vague and not sufficiently restrictive to properly identify all properties that were atypical. Other letters expressed the opposing view that the criteria were so broad that all residential real estate would have one or more of the stated factors with the result that almost all residential properties would have to be appraised by State certified appraisers. Others were concerned that the definition would not be workable because many atypical factors could not be identifed until an appraisal is conducted.

In response to these comments, the FDIC has amended this definition. Under the final rule, an appraisal will be deemed to be complex if the property to be appraised, the form of ownership, or market conditions are atypical. The list of factors that might make an appraisal complex has been moved to the preamble to emphasize that this list is only illustrative. Moreover, the FDIC has adopted a presumption that appraisals of 1-to-4 family residential property will be noncomplex. Finally, appraisals of any type of property rendered in connection with any transaction having value less than $250,000 may be performed by a competent licensed appraiser, eliminating the need of determining complexity of the property.

Federally related transaction. Several commenters suggested that the definition be modified to exclude additional types of real estate-related financial transactions. The definition that is taken directly from the section 1121 of FIRREA has not

been amended. However, § 323.3(a) was expanded, thereby excluding a wide range of affected transactions from the definition.

Market value. There were several letters recommending various changes to the definition of market value including the suggestion that the footnote in the preamble be inserted into the text of the regulation. The FDIC believes that the definition, which is widely used in connection with mortgage lending and by a number of governmental agencies, does not require amendment.

Real estate-related financial transaction. Comments requested that this definition be modified to specifically exclude certain transactions. The definition that is taken directly from the section 1121 of FIRREA has not been amended. However, § 323.3(a) was expanded, thereby excluding a wide range of affected transactions from the requirements of the regulation.

State certified appraiser. A commenter pointed out that certification criteria will be adopted by the Appraisal Qualifications Board of the Appraisal foundation (not the Foundation itself). The FDIC has amended this definition accordingly.

Transaction value. Comments requested a clarification of the use of the term with respect to a interest in pooled loans, such as an investment in mortgage backed securities. The regulation was amended to provide that the definition applies to each loan in a pool, but not to the pool itself.

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Section 323.3 Appraisal not required: transactions requiring a State certified or licensed appraiser.

(a) Appraisal not Required.

De minimis. Two-thirds of all respondents requested that the *de minimis* level be increased, suggesting cut-offs from $20,000 to $250,000, with $100,000 being the amount most frequently mentioned. The comments indicated that the greatest dollar volume of loan losses center in development, construction, and other large speculative real estate loans, not in small credits. Commenters raised the argument that for small transactions increased costs to the regulated institutions and their customers would be substantially greater than the benefits of reduced loan losses. Comments stated that the financial impact of requiring the use of certified or licensed appraisers for real estate-related financial transactions is proportionately greater for transactions involving low dollar amounts, placing a greater burden on small farms and business, consumers financing the purchase of low income housing, and other borrowers with modest financial resources. In respect to these comments, the FDIC has raised the *de minimis* amount to $50,000. The FDIC believes that the higher figure is appropriate in light of the protections afforded by the FDIC's Guidelines for Real Estate Appraisal Policies and Review Procedures and the absence of evidence that transactions below $50,000 have created systemic risk.

Some commenters expressed concern that a higher *de minimis* would exclude too many 1-to-4 family residences that had been a past problem. However, the FDIC believes that many of those problems arose in multi-loan situations that will be covered by the definitions of "transaction value" and "tract development".

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Other comments proposed alternatives to the *de minimis* test, including exempting transactions if the ratio of the loan to the value of collateral was sufficiently small, setting a higher *de minimis* cut-off based on the strength of the institution in question, and exempting small town banks altogether. The FDIC considered the advantages of the alternatives proposed, but has concluded that each presents significant problems. For instance, an appraisal would be necessary in many cases before one could accurately determine the loan-to-value ratio. In addition, an exemption of small town institutions results in a question of "fairness" and appears to go beyond the intent of title XI. The FDIC believes that the increased *de minimis* amount will address many of the concerns expressed in the comments.

Abundance of caution. Comments suggested changes to the explanation of "abundance of caution" that would expand its scope. The FDIC believes there are very few transactions that would have exactly the same terms without the real estate collateral. The final rule maintains the "abundance of caution" provision as it appeared in the proposal.

Leases. Several comments suggested that an appraisal should not be required for many leases. "The FDIC believes that there is very limited loss exposure in operating leases. Accordingly, the final regulation includes a provision that a lease that is not the economic equivalent to a purchase or sale of real estate does not require an appraisal.

Renewals. Comments requested that renewals of loans be exempt from the requirements of the regulation. The FDIC believes that there is little risk in renewing performing real estate loans to financially sound borrowers. Accordingly, the regulation does not require this type of loan to be reappraised when renewed.

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Pooled loans. As noted in the discussion of the definition of "transaction value" above, the FDIC received requests for clarification on how the regulation applies to the purchase of mortgage-backed securities and other pooled loans. The FDIC believes that such purchases should not require additional appraisals on the underlying real estate collateral. Thus, the regulation exempts such transactions provided that the underlying loans in the pool or security are supported by appraisals conforming to this regulation when the loans were originated.

(b) Transactions Requiring a State Certified Appraiser

Several commenters suggested that State certified appraisers were being required for a broader range of transactions than was mandated by title XI while a few letters expressed the opposing view that the regulation should require greater use of these knowledgeable and experienced professionals. Regulated institutions in rural areas expressed concern that certified appraisers might not be available locally to perform appraisals and if available may not have experience in valuing rural and farm properties. Comments suggested that requiring the use a certified appraiser when the value of a federally related transaction exceeds 10 percent of an institution's Tier 1 capital places smaller banks at a competitive disadvantage since it would be required to obtain a certified appraisal for the same transaction which a larger institution could enter into using a licensed appraiser. Some comments requested that licensed appraisers be permitted to perform complex 1-to-4 family residential and commercial property appraisals below a certain value. As previously noted in the discussion of definitions, commenters suggested that complexity frequently could not be determined until the property is appraised.

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The FDIC recognizes that there may be only a limited number of State certified appraisers and that size of loan and/or value of the collateral should be factors taken into consideration in the allocation of this scarce resource. In addition, § 323.6(b), the competency provision, disallows the use of a State licensed appraiser who is not capable of properly evaluating the real property. The FDIC also concurs with the statement that the 10% of Tier 1 capital requirement would adversely and unnecessarily affect smaller institutions.

In response to these comments, the final regulation permits licensed appraisers to perform appraisals for all federally related transactions with transactions values less than $250,000 including complex residential, commercial and agricultural properties. In addition, the final rule does not include the 10% Tier 1 capital provision and allows the regulated institution to initially presume that any appraisal of residential property is non-complex.

Section 323.4 Appraisal Standards

(a) Minimum Standards

(1) *Compliance with USPAP; departure provision.* Comments expressed concern that regulated institutions would be required to comply with the USPAP without having an opportunity to comment on the standards. Some suggested that the FDIC should develop its own standards, stating that the Appraisal Foundation did not represent the majority of the appraisal industry. However, title XI specifically requires the FDIC, at a minimum, to follow "generally accepted appraisal standards as evidenced by the appraisal standards promulgated by the Appraisal Standards Board of the Appraisal Foundation."

Nevertheless, because the Appraisal Standards Board has amended the USPAP since the proposal was published, the FDIC intends to seek public comment on the revised USPAP when available, as noted above. The FDIC may amend the regulation as a result of any comments received. Moreover, future amendments to the USPAP will not apply to federally related transactions within the jurisdiction of the FDIC until the public has been afforded an opportunity to comment.

Comments requested that the proposal be amended to permit the use of USPAP Departure provision for certain transactions. For the reasons stated in the section-by-section analysis of this rule, the FDIC believes that the Departure Provision in the USPAP is inconsistent with the intent of title XI and therefore has not amended this part of the standard. This is not to say that the Departure Provision may not be used in situations where this regulation requires an appraisal.

(5) *Sales history.* Comments suggested that the requirement to report sales histories should not always be required. For the reasons stated in the section-by-section analysis of this preamble, the FDIC believes that this standard is necessary to ensure that accurate appraisals are prepared and therefore has retained this standard in the final rule.

(6) *Revenues, expenses and vacancies.* A comment on this standard suggested that it should also require an appraiser to analyze and report current expenses for income-producing property. The standard has been changed to incorporate that suggestion. In addition, the term "rents" has been changed to "revenues" to clarify that income may be generated from sources other than merely rents.

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(9) *Deductions and discounts.* Commenters asked for clarification on how to apply this standard to construction lending. The section-by-section analysis of this preamble has been expanded to clarify the application of this standard.

(12) *Legal description.* Comments sought clarification on what type of legal description was required by the standard. The preamble has been amended to specifically state that the description contained in a deed is satisfactory.

(13) *Personal property, fixtures, and intangible items.* Comments requested that an appraiser not be required to value personal property that is located on the real estate. The FDIC believes that inclusion or exclusion of personal property can have a significant impact on the value of real estate and therefore its effect should be disclosed in the appraisal. Accordingly this standard has not been amended.

(14) *Use of recognized appraisal approaches.* Comments stated that it is unnecessary to use all three recognized approaches for every appraisal. While it is recognized that all appraisal approaches are not always possible or appropriate, the FDIC believes that the absence of an approach should be adequately explained to determine the adequacy of the appraisal and therefore has retained this standard unchanged.

Section 323.5 Appraiser Independence

There were various comments concerning appraiser independence. Some comments call for greater separation of in-house appraisers from loan offices while other asserted separation was impossible in small banks. Two commenters stated the financial institution could incur lender liability if it

choose the appraiser and the borrower could later prove it suffered losses due to the choice. One suggestion was that the bank be allowed to provide a customer with a list of preapproved appraisers and let the borrower select the appraiser. Finally, comments requested that an appraisal performed for one regulated institution be able to be used by another institution. The FDIC believes that the current provisions puts regulated institutions on notice of what is required and gives them the flexibility to develop structures and procedures to ensure that appraisers are independent and not subjected to improper influences. However, the FDIC agrees that a borrower who has contacted several banks about obtaining a loan should not have to pay for different appraisals prepared at the request of the various lending institutions. Accordingly, the regulation was amended to permit an appraisal to be used by more than one regulated institution under certain circumstances.

Section 323.6 Professional Association Membership; Competency

Membership in appriasal organizations. As noted above under the authority, purpose and scope section, comments questioned whether title XI empowered the financial institution regulatory agencies to preclude hiring an appraiser based solely on membership or lack of membership in an appraisal organization. The FDIC believes that Congressional intent of prohibiting discrimination is shown in section 1122(c) of FIRREA. Moreover, the FDIC believes that the safety and soundness of the regulated institution is best protected by requiring it to look beyond the particular affiliation of an appraiser to his or her education and experience when determining competency. Accordingly, this provision has not been amended.

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C. Section-by-Section Analysis

Section 323.1 Authority, Purpose, and Scope

This section identifies title XI of FIRREA and other as the authority under which this regulation is promulgated. Further, it states who must comply with the regulation, including the FDIC and institutions regulated by the FDIC ("regulated institutions").

Section 323.2 Definitions

Except where noted below, the definitions set forth in title XI shall apply to the terms used in this regulation.

—*Appraisal.* This definition currently is used by nineteen federal agencies.[5] The FDIC believes that this widespread use and acceptance will produce consistent appraisals.

—*Complex 1-to-4 family residential property appraisal.* Section 1113 of FIRREA allows the use of a State licensed appraiser for, among other federally related transactions, 1-to-4 family residential property appraisals, "unless the size and complexity requires a State certified appraiser." The FDIC deems a "complex 1-to-4 family residential property appraisal" to be one in which the property to be appraised, form of ownership, or market conditions are atypical. Examples of atypical factors may include age of improvements, architectural style, size of improvements, size of lot, neighborhood land use, potential environmental hazard liability, leasehold interests, or other unusual factors. This list is illustrative only.

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5. *See* 49 CFR Part 24, "Uniform Relocation Assistance and Real Property Acquisition Regulations for Federal and Federally Assisted Programs.

—*Market value.* This definition is commonly used in connection with mortgage lending by a number of government agencies and others. The definition contemplates the consummation of a sale as of a specified date and the passing of title from seller to buyer under open and competitive market conditions requisite to a fair sale. It is designed to provide an accurate and reliable measure of the economic potential of property involved in federally related transactions. Moreover, the FDIC believes that widespread acceptance and use of this definition will provide consistency to appraisals.

In applying this definition of market value, adjustments to the comparables must be made for special or creative financing or sales concessions. No adjustments are necessary for those costs that are normally paid by sellers as a result of tradition or law in a market area; these costs are readily identifiable since the seller pays these costs in virtually all sales transactions. Special or creative financing adjustments can be made to the comparable property by comparisons to financing terms offered by a third party financial institution that is not already involved in the property or transaction. Any adjustment should not be calculated on a mechanical dollar-for-dollar cost of the financing or concession, but the dollar amount of any adjustment should approximate the market's reaction to the financing or concessions based on the appraiser's judgment.[6]

—*Real estate-related financial transactions.* This definition

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6. This paragraph regarding comparables is taken from the standard definition of "market value" used by the Federal Home Loan Mortgage Corporation ("FHLMC"), the Federal National Mortgage Association ("FNMA"), and OTS, among others. By including this paragraph in the preamble rather than the regulation, the FDIC does not intend to suggest any change in the interpretation or application of the definition of "market value" as this term currently is used.

is the same as that set forth in section 1121(5) of FIRREA, except that "and" is replaced with "or" throughout so as to clarify the intent of Congress.

—*State certified appraiser.* This classification applies to appraisers who are recognized by the States as being more knowledgeable of and experienced in appraisals than are licensed appraisers. Section 1116 of FIRREA contemplates that each State or territory will adopt standards and procedures, consistent with the purposes of title XI, for obtaining the designations of "State certified appraiser." To be consistent with title XI, each State's standards and procedures must require its certified appraisers to meet, at a minimum, the criteria for certification issued by the Appraisal Qualifications Board of the Appraisal Foundation. Moreover no State or territory may certify an appraiser under title XI unless that individual passes an examination, administered by the State or territory, that is consistent with and equivalent to the Uniform State Certification Examination issued or endorsed by the Appraisal Foundation. The rule does not prevent a State from establishing additional certification criteria.

Under FIRREA, the FDIC is authorized to establish certification criteria in addition to those adopted by a given state. Additionally, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council may issue a written finding that the certification criteria of a State or territory are inadequate for specific reasons. Thus, an individual may be a "State certified appraiser" only if (a) The Individual complies with all state-imposed criteria and additional criteria, if any, imposed by the FDIC, and (b) the appraiser certifications and licenses of a state have not been rejected by the Appraisal Subcommittee.

—*State licensed appraiser.* Each state may elect to adopt licensing criteria that are less rigorous than certification criteria. However, licensing criteria must be adequate to protect federal financial and public policy interests. For example, simply "grandfathering" all existing appraisers generally would not be acceptable. Rather, the states and territories are to design criteria that will insure that licensed appraisers will have the experience and training sufficient to comply with this regulation.

The Appraisal Subcommittee of the FFIEC has indicated that in its statutory oversight of the state licensing process it expects the states to adopt meaningful qualification standards for licensed appraisers, including testing, experience and education requirements. Further, the Subcommittee has stated its position that the qualifications criteria for "residential real property appraiser" adopted by the Appraiser Qualifications Board of the Appraisal Foundation satisfy its expectations. The FDIC is a member of the Appraisal Subcommittee and fully supports its position.

As with State certified appraiser criteria, the FDIC is authorized to impose additional licensing requirements. Moreover, the Appraisal subcommittee is charged with monitoring state appraiser certifying and licensing agencies, and may reject state certifications and licenses if a state's appraisal policies, practices, or procedures are found to be inconsistent with title XI or this regulation.

—*Tract development.* A tract development may be units in a subdivision, condominium project, timeshare project, or any similar project meant to be sold as individual units over a period of time. A project will be deemed to be a tract development if it is currently, or is intended to be, offered for sale as a single development.

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—*Transaction value.* This definition is used to determine which transactions require a State certified appraiser and which require a State licensed appraiser. The FDIC will consider a series of related transactions as one transaction if it appears that a regulated institution is attempting to evade the requirements of title XI of FIRREA or this regulation.

Section 323.3 Appraisal Not Required; Transactions Requiring State Certified or Licensed Appraiser

(a) *Appraisal not required.* Section 1121(4) of FIRREA defines a federally related transaction as a real estate-related financial transaction that, among other things, requires the services of an appraiser. The FDIC recognizes that not all real estate-related financial transactions will require an appraiser. For instance, an appraisal would not be needed where a lien on real property has been taken as collateral solely through an abundance of caution. Collateral will be deemed to be taken in an abundance of caution where the terms as a consequence have not been made more favorable than they would have been in the absence of the lien. Accordingly, this exception is intended to have very limited application. In addition, the FDIC does not require an appraisal for a real estate-related financial transaction having a transaction value of $50,000 or less. A third instance where an appraisal is not required is a lease that is not the economic equivalent of a purchase or sale or real estate. An example of such a lease is a sublease by a bank of a portion of its premises to an unrelated third party. On the other hand, an assignment of a lease as collateral for the extension of credit wuld be an example of the economic equivalent of a purchase or sale. Fourth, the FDIC will not require an appraisal for the renewal of a loan, provided that the borrower has made all scheduled payments under the note, no new funds are advanced (other than as previously agreed), the

borrower remains creditworthy and the property's collateral value has not obviously and materially deteriorated. Finally, an appraisal will not be required if a regulated institution purchases an interest in a loan secured by real property or mortgage-backed securities, if the underlying collateral was appraised in accordance with this regulation at the time the loan was originated. If the property was not adequately appraised, then the regulated institution must order an appraisal of each property that serves as collateral.

The FDIC has concluded that the *de minimis* amount raised to $50,000 continues to protect federal financial and policy interest while reducing the cost of compliance to the public and regulated institutions. The FDIC may change the *de minimis* amount by amendment to the regulation should additional experience with the rule indicate a different level is appropriate. For transactions below the *de minimis* level, the FDIC does not intend to discourage any regulated institution from obtaining an appraisal in accordance with this regulation. In addition, any real estate-related financial transaction that does not require a State certified or licensed appraiser or use of all the standards prescribed herein should be supported by an appropriate estimate of value prepared in accordance with supervisory guidelines, general banking practice or other prudent standards, such as the FDIC Guidelines for Real Estate Appraisal Policies and Review Procedures. Pursuant to the Guidelines, an institution should obtain an adequate evaluation of real estate collateral by a competent person (who need not be a certified or licensed appraiser) before entering into any real estate-related financial transactions below the *de minimis* level.

(b) *Transactions requiring State certified appraiser.* Title XI requires a State certified appraiser to be used if the size of the

transaction and the complexity of the appraisal warrants the expertise of the State certified appraiser. The regulation requires a State certified appraiser to be used in three instances. First, all appraisals in connection with federally related transactions having a transaction value of $1,000,000 or more require a State certified appraiser, regardless of complexity. Second, all federally related transactions having a transaction value equal to or greater than $250,000, except those involving appraisals of 1-to-4 family residential properties, require a State certified appraiser. Third, 1-to-4 family residential property appraisals require a State certified appraiser if the transaction value is $250,000 or more and the appraisal will be complex.

Before hiring an appraiser, the institution should assess the project to determine the qualifications that an appraiser will need to complete the appraisal assignment and whether the transaction, due to its complexity, would require a certified appraiser. A regulated institution may presume that appraisals of 1-to-4 family residential property are not complex, unless the institution has readily available information that suggests that a given appraisal will be complex. Such information may be provided, for instance, on a loan application. If the institution or assigned appraiser discovers during the assignment that the transaction is atypical or beyond the appraiser's expertise, the appraiser is required to disclose this situation to the institution and take the necessary action to remedy the deficiency. A certified appraiser could then be employed or the licensed appraiser could complete the appraisal and have a certified appraiser review and co-sign the appraisal report.

(c) *Transactions requiring either a State certified or licensed appraiser.* Any federally related transaction not otherwise exempt that does not require the services of a State

certified appraiser must be performed by, at a minimum, a State licensed appraiser. State licensed appraiser may perform appraisals rendered in connection with any federally related transaction having transaction value up to, but not including, $250,000. In addition, State licensed appraisers may perform appraisals of 1-to-4 family residential property for transactions with a value up to $1,000,000 if the appraisal will not be complex.

The following table summarizes by value of transaction the professional designation of appraisers required.

Summary of Appraiser Requirements

Transaction value	Residential		Nonresidential
	Noncomplex	Complex	
$0 to $50,000	No requirement	No requirement	No requirement.
Over $50,000 to less than $250,000	Licensed or certified	Licensed or certified	Licensed or certified.
$250,000 to less than $1,000,000	Licensed or certified	Certified	Certified.
$1,000,000 or more	Certified	Certified	Certified.

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Section 323.4 Appraisal Standards

(a) *Minimum standards.* Section 110 of FIRREA instructs the FDIC to prescribe appropriate standards for the performance of appraisals made in connection with federally related transaction within its jurisdiction. Further, section 1110 mandates that the standards require, at a minimum, that appraisals be written and that they conform to generally accepted appraisal standards as evidenced by those issued by the Appraisal Standards Board of the Appraisal Foundation. The FDIC is empowered to require compliance with additional appraisal standards if it makes a written determination that such additional standards are required in order to properly carry out its statutory responsibilities. Section 323.4 of the regulation incorporates the minimum standards set forth in the statute, while listing additional criteria that shall apply to all appraisals performed as required under this regulation for federally related transactions.

In enacting title XI of FIRREA, Congress was responding to perceived problems in the appraisal industry. These problems were identified by the House Committee on Government Operations during a series of hearings,[7] and have been cited repeatedly in the legislative history of title XI.[8] The FDIC has adopted the following standards to further the legislative intent in addressing these problems. These standards are designed to

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7. House Comm. on Government Operations, *Impact of Appraisal Problems on Real Estate Lending, Mortgage Insurance, and Investment in the Secondary Market*, H.R. 99-891, 99th Cong., 2d Sess. (1986).

8. *See, e.g.*, 135 Cong. Rec. S4004 (daily ed. April 17, 1989) (Statement of Sen. Dodd); H.R. Rep. No. 100-1001, 100th Cong. 2d Sess. pt. 1, at 19, 21-26; 133 Cong. Rec. H10709 (daily ed. Nov. 20, 1987) (statement of Cong. Barnard); 132 Cong. Rec. H3452 (daily ed. June 7, 1986) (statement of Cong. Barnard).

contribute to safe and sound banking practiced by requiring reliable appraisal reports. Appraisals performed in connection with federally related transactions are to comply with these standards on the regulation's effective date September 19, 1990.

(1) *Compliance with USPAP; departure provision.* This standard incorporates the current standards in the USPAP and clarifies that the Departure Provision[9] in the USPAP is inapplicable to appraisals conducted in connection with federally related transactions within the FDIC's jurisdiction. The FDIC believes that the Departure Provision allows appraisal services to be perfomed which produce something different from an "appraisal" as contemplated by title XI of FIRREA. For instance, in accordance with the Departure Provision and consistent with current USPAP requirements, a letter opinion might be produced that could be silent about trends of rents, vacancies, or overbuilding. Explanatory comments in the USPAP regarding the Departure Provision in the USPAP cite examples of when the departure provision might apply;[10] however, for purposes of the regulation, such services are not appraisals as this term is used in title XI. The FDIC believes that the Departure Provision in the USPAP allows for the omission of data that should be included in developing and reporting all appraisals rendered in connection with federally related transactions and, therefore, has determined that the departure Provision shall not apply to such appraisals.

The FDIC solicits comment on any revisions to the USPAP

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9. The Departure Provision enables appraisers to "perform an assignment that calls for something less than or different from the work that would otherwise be required by the [USPAP]."

10. These examples include introducing into evidence during a judicial proceeding a one-page summary that incorporates by reference an appraiser's file or preparing a brief update of a previously prepared appraisal.

that are relevant to federally related transactions. Changes to the USPAP made after the effective date of this regulation shall not be applicable to federally related transactions until there has been notice of the changes and the opportunity for interested persons to comment.

(2) *Disclosure of competency.* An appraiser is required to have the appropriate knowledge and experience that will be required to complete an assignment competently. If such knowledge and experience is initially lacking, the appraiser must disclose in the appraisal both this fact and the steps taken to comply with the Competency Provision in the USPAP.

(3) *Market value.* This standard requires an appraisal to document an appraiser's opinion of a property's "market value" as this term is defined. The definition of "market value" was developed by FNMA and FHLMC with the input of many professional appraisal organizations. Without such a standard, a lender might select a definition of value that allows the value of real property to be increased by favorable financing, going concern value, or special value to a specific user. This standard proposes to provide to interested parties the information necessary to determine the value of a property.

(4) *Written appraisals; forms.* This standard sets forth the legislative mandate that all appraisals be written. Moreover, it requires an appraisal to be sufficiently descriptive to enable a reviewer to readily ascertain the estimated value reported and the rationale for that estimate. The appraisal may be in a narrative format or on a form chosen by an appraiser, but the appraisal must comply with all other provisions of the regulation. A form not initially designed for use in connection with federally related transactions may be used provided that it is modified as necessary to comply with the requirements of title XI and this regulation.

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Regardless of the format selected, the appraisal must be able to be readily understood by a third party and must reflect the complexity of the property that is appraised. This will enable the reader of the appraisal to independently determine its adequacy based upon the characteristics of the collateral appraised.

(5) *Sales history.* This standard is designed to enable a reviewer to compare an appraiser's opinion of a property's market value with recent sales prices. In addition to giving the reviewer a basis by which to evaluate the accuracy of the subject property appraisal, it also will assist the reviewer in identifying recent trends in market prices. For instance, a sales history may identify a single sale or a series of sales at artificially inflated prices.

Sales histories are required for one year for 1-to-4 family residential property and for three years for all other types of property. A more demanding reporting standard for nonresidential property is appropriate because larger loan amounts are generally granted, and hence larger risk to the regulated institution incurred, when the loan security is not a 1-to-4 family dwelling.

(6) *Revenues, expenses and vacancies.* An appraisal should disclose current income produced by a property if the property will continue to be sued to generate income after a transaction is consummated. This information is essential for an accurate picture of the market value of an income-producing property. Appraisal values should be predicated upon current revenues, expenses and vacancies for property utilized in such a manner. That is, appraisals should be based upon income that can realistically be earned under current market and economic conditions (in light of rents being earned on comparable

properties), rather than upon estimated or projected income that cannot be supported by current market conditions. If an appraiser reports a high current vacancy, the lender may have to impose special conditions on the loan.

(7) *Marketing period.* This standard requires an appraiser to employ a marketing period that is reasonable in light of a given property's characteristics and market conditions, and to disclose the assumptions used. An appraiser's opinion of market value will depend in part on the appraiser's estimate of how long a given piece of property will remain for sale. For instance, an appraisal using a long marketing period may produce a higher market value than would an appraisal using a shorter marketing period. This information will better enable the reader of the appraisal to assess its accuracy.

(8) *Trend analysis.* An appraisal should inform the reader of any market trends, regardless of whether the trend reflects rising or declining values. Such trends might include, for example, increasing vacancy rates, greater use of rent concessions, or declining sales prices. Identification of negative trends is particularly important so that a regulated institution may avoid extending credit on the basis of insufficient collateral. Market trends may be indicated in market activity on the subject property, such as listings, options, or sales agreements; accordingly, such activity should be disclosed.

(9) *Deductions and discounts.* This standard is designated to avoid having appraisals prepared using unrealistic assumption. For federally related transactions, an appraisal is to include an "as is" market value. This is the value of the property in its current physical condition and subject to the zoning in effect as of the current date of value. For properties where improvements are to

be constructed or rehabilitated, the regulated institution may request a value based on stablized occupancy or a value based on the sum of retail sales. However, the sum of retail sales for a proposed developement is not the market value of the development. For proposed developments that involve the sale of individual houses, units, or lots, the appraiser must analyze and report appropriate deductions and discounts for holding costs, marketing costs and entrepreneurial profit. For proposed and rehabilitated rental developments, the appraiser must make appropriate deductions and discounts for items such as leasing commissions, rent losses and tenant improvements from the market value estimate based on stabilized occupancy.

(10) *Prohibited influences.* All appraisals are to be performed without pressure from someone who desires a specific value. Accordingly, every appraisal rendered in connection with a federally related transaction shall include a statement to the effect that employment of the appraiser was not conditioned upon the appraisal producing a specific value or a value within a given range. Similarly, future employment prospects should not be dependent upon an appraisal producing a specified value. Employment and compensation should not be based on whether a loan application is approved, as this, too, would exert pressure on an appraiser to render whatever appraisal is necessary for the loan to be approved.

(11) *Self-contained appraisals.* This standard requires an appraisal to contain all information necessary to enable a reader of an appraisal to understand the appraiser's opinion. The appraisal should not incorporate by reference a document that is not readily available to the reader. Studies prepared by a third party should be verified to the extent his or her assumptions or conclusions are used. In addition, the appraiser's acceptance or rejection of a third party study and its impact of value should be

fully explained. The appraisal itself should enable the reader to understand the conclusion without having to refer to numerous other documents. Moreover, the conclusion must be reasonable in light of the information set forth in the appraisal. These requirements will force an appraiser to obtain adequate data before issuing an opinion of value.

(12) *Legal description.* A legal description of the property is to be included in an appraisal so as to avoid confusion that may arise from less precise identification. The description of real property contained in a deed will suffice. This requirement enables a reader to compare the legal description in the appraisal to the legal description in the loan documents. The legal description is to be provided in addition to, and not in lieu of, the description required in the USPAP.

(13) *Personal property, fixtures, and intangible items.* An appraisal is to include a separate assessment of personal property, fixtures, or intangible items that are attached to or located on real property if the personal property, fixture, or intangible item affects the market value of the real property. Furniture and fixtures should have separate valuations because their economic life is shorter than real property improvements and may require special lending or investment considerations. If the personal property, fixtures, or intangible item is not a part of the transaction, then this fact should be stated and the impact on market value should be disclosed. Favorable loan financing or any business interest or other intangible item should be valued separately within the appraisal. These requirements will help provide a reader with a more complete understanding of the market value of the real property as it will be at the time the transaction is entered into.

(14) *Use of recognized appraisal approaches.* At the

request of clients, some appraisers have not prepared cost estimates of value, estimates of value based on the capitalization of income, or value estimates based on direct sales comparisons. This standard requires an appraiser to address each of these recognized approaches to market value and explain how each approach was used. However, if one or more approaches is not used, an appraiser is to explain the elimination of any approach. This requirement is intended to produce appraisals made only after the three major approaches to market value have been considered and reconciled, thereby improving the accuracy of the appraisal. Disclosure of the fact that an approach was not used will assist the reader in evaluating the adequacy of the appraisal.

(b) *Unavailability of information.* The FDIC realizes that some information required by the USPAP or this regulation to be in an appraisal may, on occasion, be unavailable. For example, historic rents will not exist for a building under construction at the time of appraisal. However, an appraisal should inform the reader of any material information that is unavailable and why such information could not be obtained, so as to assist the reader in reviewing the appraisal.

(c) *Additional standards.* The standards required by this regulation are the minimum standards to be met by every appraisal required under this regulation in connection with a federally related transaction. However, the FDIC and regulated institutions may employ additional standards if circumstances so warrant.

Section 323.5—Appraiser Independence

An appraiser's goal should be to produce an objective opinion about the market value of a property. This objectivity may be comprised if the appraiser is involved in the transaction,

such as deciding whether to extend credit to be secured by such property. Similarly, a direct or indirect interest in the property appraised may undermine the accuracy of the appraisal. A direct interest would arise, for example, by owning all or part of property being appraised. An indirect interest would arise if, for example, by owning all or part of property being appraised. An indirect interest would arise if, for example, an appraiser owns property adjacent to the parcel being appraised. This indirect interest would extent to any property whose value is likely to be affected by an appraisal, if the appraisal is the proximate cause for the effect. Moreover, the interest may be nonpecuniary, such as a desire to help an associate obtain a loan.

To further the goal of appraiser independence, the FDIC requires that fee appraisers (that is, appraisers not permanently employed by a given regulated institution) be hired by a regulated institution or its agent rather than the borrower. An appraisal performed for one regulation institution may be used by another if the latter institution has adequately reviewed the appraisal, documented such review, and found the appraisal to have complied with this regulation. In order to avoid potential conflicts of interest, staff appraisers (appraisers that are permanently employed by a regulated institution) should not be supervised, controlled, or influenced by loan underwriters, loan officers, or collection officers.

The FDIC recognizes that in certain cases it may be necessary for loan officers and directors to perform appraisals. Such cases would depend on an institution's particular circumstances; an example would be a small rural bank where the only qualified individual to perform appraisals is a loan officer, and separating this person from the loan and collection departments is impossible. In such situation, the FDIC recommends that this individual perform appraisal work on loans

in which he or she is not otherwise involved. In cases where loan officers or directors perform appraisals, regulated institutions are expected to ensure that the appraisers are qualified and that appraisal reports are adequate.[11] Directors and officers should abstain from any vote and/or approval involving assets on which they had performed an appraisal. In all, sufficient safeguards should be in place to permit appraisers to exercise independent judgment, thereby ensuing the validity of the appraisal process.

Section 323.6—Professional Association Membership; Competency

(a) *Membership in appraisal organizations.* The legislative history of title XI evidences an intent to prohibit discrimination against appraisers solely by virtue of membership or lack of membership in a particular appraisal organization.[12] Accordingly, this regulation prohibits any entity covered by title XI from basing decisions regarding the employment of appraisers solely on membership or lack of membership in an appraisal organization. An institution should review the qualifications of appraisers rather than the qualifications of appraisal organizations to insure that a qualified individual is being employed. Membership in an organization may be considered; however, it may not be the sole determining factor in accepting or rejecting an appraiser.

(b) *Competency.* The license or certification by itself does

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11. It should be noted that directors and officers who perform appraisals in connection with federally related transactions must be licensed or certified, as appropriate.

12. *See, e.g.*, House Banking Committee Report at 484; *See also* H.R. Conf. Rep. No. 101-222, 101st Cong., 1st Sess., at 457 (1989).

not prove the appraiser's competency. Not all appraisers are competent to perform every type of appraisal that will be needed in connection with federally related transactions. For instance, an appraiser who is experienced in appraising shopping centers may not possess sufficient expertise to appraise a golf course. A financial institution should look beyond an individual's title to determine if he or she has the experience and training needed to perform the appraisal. This provision is not intended to prohibit, in every circumstances, an individual from appraising a type of property with which he or she is not familiar. However, in such instances, an appraiser may perform the appraisal only in accordance with the Competency Provision in the USPAP. In addition, an individual who is not a State certified or licensed appraiser may assist in the preparation of an appraisal if he or she is directly supervised by a licensed or certified appraiser (as appropriate), and the appraisal is approved and signed by a certified or licensed appraiser.

Section 323.7—Enforcement

Section 1120 of FIRREA vests the FDIC with the authority to bring an action for civil money penalties against a regulated institution within its jurisdiction. The regulation makes clear that additional enforcement remedies available to the FDIC under the Federal Deposit Insurance Act or other statutes also apply. These can include civil money penalties and cease and desist orders, as well as orders of removal and prohibitions against institutions and institution-affiliated parties. FIRREA specifically provides that "institution-affiliated parties" includes, but is not limited to, appraisers.[13]

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13. *See* FIRREA, sections 204(f)(6) and 901(b)(1).

Appendix P

Regulatory Flexibility Act Analysis

Title XI of FIRREA requires the FDIC to establish standards for performing appraisals in connection with federally related transactions within its jurisdiction. In addition, title XI requires the FDIC to distinguish those transactions that require State certified appraisers from those that require State certified or licensed appraisers. This regulation is in response to this legislative mandate.

After considering the comments received, the FDIC has made a number of significant changes to the initial proposal that should help to reduce cost, particularly for smaller institutions, and to focus the regulation on those transactions where appraisal standards are most important. The principal changes are as follows:

(a) The *de minimis* cutoff has been raised to $50,000, thus eliminating smaller loans from the requirements of this regulation and focusing the regulation on those large transactions where the exposure to loss is greater. Because many of these large transactions would normally involve an appraisal under current practices, the marginal cost of mandatory appraisals is likely to be relatively insignificant, at least after a period of adjustment to the new requirements.

(b) The revised regulation permits competent State licensed appraisers, rather than only State certified appraisers, to perform any type of appraisal in transactions involving amounts up to $250,000. This should help minimize the costs to institutions that concentrate on these smaller loans.

(c) The revised regulation also expands the number of

instances when licensed appraisers may be used, by eliminating the additional criterion in the proposal that would have required a certified appraiser where the transaction value exceeded 10 percent of Tier 1 capital.

(d) The revised regulation also clarifies that most appraisals of 1-to-4 family residential property will be presumed to be non-complex, and therefore allows for greater use of State licensed appraisers.

(e) Finally, the revised regulation exempts from the requirements of this regulation certain additional types of transactions, including transactions resulting from a maturing extension of credit under certain circumstances, leases that are not the economic equivalent of a purchase, and purchases of pooled loans or interests in real property if conforming appraisals have been performed.

The FDIC anticipates that the regulation may have a tendency to increase costs, to some degree, for borrowers and regulated institutions, since FIRREA contains no exception for small institutions. The cost increase may stem from at least two aspects of the rule. First, since regulated institutions are required to use certified or licensed appraisers, the cost of an appraisal may rise somewhat. Some borrowers may resist the increased appraisal cost and decide not to take out a loan secured by real estate. Alternatively, some regulated institutions may elect to absorb all or a portion of any increased appraisal cost. Second, the regulation includes certain provisions that go beyond the FDIC's existing appraisal guidelines. Those provisions could add to appraisal costs.

On the other hand, the regulation should serve to decrease

costs to regulated institutions of all sizes. Such regulated institutions will have better information about the value of the real estate involved in federally related transactions and can better ensure that each loan is collateralized adequately. As a result, the events of default should be reduced, with a corresponding reduction in loan losses. In addition, for those institutions that already have strong appraisal policies or procedure that exceed minimum supervisory standards, the marginal costs of the regulation should be limited. On balance, the FDIC believes that adoption of this regulation will not have a significant adverse economic impact on a substantial number of small business entities, in accordance with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*).

Paperwork Reduction Act

The collection of information contained in § 323.4 of this final rule has been approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 3064-0103. The estimated average burden associated with the collection of information in this final rule is 0.25 hour per response, or a total of 24.75 hours per respondent annually. This estimate represents the hours that are in excess of what institutions should prudently already be expending.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Assistant Executive Secretary (Administration), Room F-400, Federal Deposit Insurance Corporation, Washington, DC 20429, and to the Office of Management and Budget, Paperwork Reduction Project (3064-0103), Washington, DC 20503.

Appendix P

List of Subjects in 12 CFR Part 323

Banks, Banking, Mortgages, Real estate appraisal, Reporting and recordkeeping requirements, Savings associations.

For the reasons set out in the preamble, the FDIC hereby adds part 323 to subchapter B of chapter III of 12 CFR to read as follows [reproduced at ¶ 66,031-66,031R].

* * * * *

By order of the Board of Directors.

Dated at Washington, DC, this 24th day of July 1990.

Robert E. Feldman,

Deputy Executive Secretary.

Appendix P

PART 323—APPRAISALS

Sec.

323.1 Authority, purpose, and scope.
323.2 Definitions.
323.3 Appraisal not required; transactions requiring a state certified or licensed appraiser.
323.4 Appraisal standards.
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Appendix A to Part 323—Excerpts from the Uniform Standards of Professional Appraisal Practice applicable to federally related transactions.

AUTHORITY: Sec. 1101-22, Pub. L. 101-73, 103 Stat. 183, 511-19 (12 U.S.C. 3331-51).

SOURCE: The provisions of this Part 323 appear at 55 Fed. Reg. 33888, August 20, 1990, effective September 19, 1990, except as otherwise noted.

§ 323.1 Authority, purpose, and scope.

(a) *Authority.* This part is issued under 12 U.S.C. 1818, 1819 ["Seventh" and "Tenth"] and title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA") (Pub. L. 101-73, 103 Stat. 183, 12 U.S.C. 3331 *et seq.* (1989)).

(b) *Purpose and scope.* (1) Title XI provides protection for federal financial and public policy interests in real estate related transactions by requiring real estate appraisals used in

connection with federally related transactions to be performed in writing, in accordance with uniform standards, by appraisers whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. This part implements the requirements of title XI and applies to all federally related transactions entered into by the FDIC or by institutions regulated by the FDIC ("regulated institutions").

(2) This part:

(i) Identifies which real estate-related financial transactions require the services of an appraiser;

(ii) Prescribes which categories of federally related transactions shall be appraised by a state certified appraiser and which by a state licensed appraiser; and

(iii) Prescribes minimum standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of the FDIC.

[Codified to 12 C.F.R. § 323.1]

§ 323.2 Definitions.

(a) *Appraisal* means a written statement independently and impartially prepared by a qualified appraiser setting forth an opinion as to the market value of an adequately described property as of a specific date(s), supported by the presentation and analysis of relevant market information.

(b) *Appraisal Foundation* means the Appraisal Foundation established on November 30, 1987, as a not-for-profit corporation under the laws of Illinois.

(c) *Appraisal Subcommittee* means the Appraisal Subcommittee of the Federal Financial Institutions Examination Council.

(d) *Complex 1-to-4 family residential property appraisal* means one in which the property to be appraised, the form of ownership, or market conditions are atypical.

(e) *Federally related transaction* means any real estate-related financial transactions entered into after the effective date hereof that:

(1) The FDIC or any regulated institution engages in or contracts for; and

(2) Requires the services of an appraiser.

(f) *Market value* means the most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

(1) Buyer and seller are typically motivated;

(2) Both parties are well informed or well advised, and acting in what they consider their own best interests;

(3) A reasonable time is allowed for exposure in the open market;

(4) Payment is made in terms of cash in U.S. dollars or in terms of financial arrangements comparable thereto; and

(5) The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

(g) *Real estate-related financial transaction* means any transaction involving:

(1) The sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof; or

(2) The refinancing of real property or interests in real property; or

(3) The use of real property or interests in property as security for a loan or investment, including mortgage-backed securities.

(h) *State certified appraiser* means any individual who has satisfied the requirements for certification in a state or territory whose criteria for certification as a real estate appraiser currently meet the minimum criteria for certification issued by the Appraiser Qualifications Board of the Appraisal Foundation. No individual shall be a state certified appraiser unless such individual has achieved a passing grade upon a suitable examination administered by a state or territory that is consistent with and equivalent to the Uniform State Certification Examination issued or endorsed by the Appraiser Qualifications Board. In addition, the Appraisal Subcommittee must not have issued a finding that the policies, practices, or procedures of a

state or territory are inconsistent with title XI of FIRREA. The FDIC may, from time to time, impose additional qualification criteria for certified appraisers performing appraisals in connection with federally related transactions within its jurisdiction.

(i) *State licensed appraiser* means any individual who has satisfied the requirements for licensing in a state or territory where the licensing procedures comply with title XI of FIRREA and where the Appraisal Subcommittee has not issued a finding that the policies, practices, or procedures of the state or territory are inconsistent with title XI. The FDIC may, from time to time, impose additional qualification criteria for licensed appraisers performing appraisals in connection with federally related transactions within its jurisdiction.

(j) *Tract development* means a project of five units or more that is constructed or is to be constructed as a single development.

(k) *Transaction value* means:

(1) For loans or other extensions of credit, the amount of the loan or extension of credit;

(2) For sales, leases, purchases, and investments in or exchanges of real property, the market value of the real property interest involved; and

(3) For the pooling of loans or interests in real property for resale or purchase, the amount of the loan or market value of the real property calculated with respect to each such loan or interest in real property.

Appendix P

[Codified to 12 C.F.R. § 323.2]

§ 323.3 Appraisal not required; transactions requiring a state certified or licensed appraiser.

(a) *Appraisal* not *required.* While supervisory guidelines, general banking practices or other prudent standards require an appropriate valuation of real property collateral, an appraisal performed in accordance with this part is not required for any real estate-related financial transaction in which:

(1) The transaction value is $50,000 or less;

(2) A lien on real property has been taken as collateral solely through an abundance of caution and where the terms of the transaction as a consequence have not been made more favorable than they would have been in the absence of a lien;

(3) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(4) There is a subsequent transaction resulting from a maturing extension of credit, provided that:

(i) The borrower has performed satisfactorily according to the original terms;

(ii) No new monies have been advanced other than as previously agreed;

(iii) The credit standing of the borrower has not deteriorated; and

(iv) There has been no obvious and material deterioration in market conditions or physical aspects of the property which would threaten the institution's collateral protection; or

(5) A regulated institution purchases a loan or interest in a loan, pooled loans, or interests in real property, including mortgage-backed securities, provided that the appraisal prepared for each pooled loan or real property interest met the requirements of this part, if applicable.

(b) *Transactions requiring a state certified appraiser*—(1) *All transactions of $1,000,000, or more.* All federally related transactions having a transaction value of $1,000,000 or more shall require an appraisal prepared by a state certified appraiser.

(2) *Nonresidential transactions of $250,000 or more.* All federally related transactions having a transaction value of $250,000 or more, other than those involving appraisals of 1-to-4 family residential properties, shall require an appraisal prepared by a state certified appraiser.

(3) *Complex residential transactions of $250,000 or more.* All complex 1-to-4 family residential property appraisals rendered in connection with federally related transactions shall require a state certified appraiser if the transaction value is $250,000 or more. A regulated institution may presume that appraisals of 1-to-4 family residential properties are not complex, unless the institution has readily available information that a given appraisal will be complex. The regulated institution shall be responsible for making the final determination of whether the appraisal is complex. If during the course of the appraisal a licensed appraiser identifies factors that would result

in the property, form of ownership, or market conditions being considered atypical, then either:

(i) The regulated institution may ask the licensed appraiser to complete the appraisal and have a certified appraiser approve and co-sign the appraisal; or

(ii) The institution may engage a certified appraiser to complete the appraisal.

(c) *Transactions requiring either a state certified or licensed appraiser.* All appraisals for federally related transactions not requiring the services of a state certified appraiser shall be prepared by either a state certified appraiser or a state licensed appraiser.

[Codified to 12 C.F.R. § 323]

§ 323.4 Appraisal standards.

(a) *Minimum standards.* For federally related transactions, all appraisals shall, at a minimum:

(1) Conform to the Uniform Standards of Professional Appraisal Practice ("USPAP") adopted by the Appraisal Standards Board of the Appraisal Foundation, except that the Departure Provision of the USPAP shall not apply to federally related transactions;

(2) Disclose any steps taken that were necessary or appropriate to comply with the Competency Provision of the USPAP;

(3) Be based upon the definition of market value as set forth in § 323.2(f);

(4)(i) Be written and presented in a narrative format or on forms that satisfy all the requirements of this section;

(ii) Be sufficiently descriptive to enable the reader to ascertain the estimated market value and the rationale for the estimate; and

(iii) Provide detail and depth of analysis that reflect the complexity of the real estate appraised;

(5) Analyze and report in reasonable detail any prior sales of the property being appraised that occurred within the following time periods:

(i) For 1-to-4 family residential property, one year preceding the date when the appraisal was prepared; and

(ii) For all other property, three years preceding the date when the appraisal was prepared;

(6) Analyze and report data on current revenues, expenses and vacancies for the property if it is and will continue to be income-producing;

(7) Analyze and report a reasonable marketing period for the subject property;

(8) Analyze and report on current market conditions and trends that will affect projected income or the absorption period, to the extent they affect the value of the subject property;

(9) Analyze and report appropriate deductions and discounts for any proposed construction, or any completed properties that are partially leased or leased at other than market rents as of the date of the appraisal, or any tract developments with unsold units;

(10) Include in the certification required by the USPAP an additional statement that the appraisal assignment was not based on a requested minimum valuation, a specific valuation, or the approval of a loan;

(11) Contain sufficient supporting documentation with all pertinent information reported so that the appraiser's logic, reasoning, judgment, and analysis in arriving at a conclusion indicate to the reader the reasonableness of the market value reported;

(12) Include a legal description of the real estate being appraised, in addition to the description required by the USPAP;

(13) Identify and separately value any personal property, fixtures, or intangible items that are not real property but are included in the appraisal, and discuss the impact of their inclusion or exclusion on the estimate of market value; and

(14) Follow a reasonable valuation method that addresses the direct sales comparison, income, and cost approaches to market value, reconciles those approaches, and explains the elimination of each approach not used.

(b) *Unavailability of information.* If information required or deemed pertinent to the completion of an appraisal is unavailable, that fact shall be disclosed and explained in the appraisal.

(c) *Additional standards.* Nothing contained herein shall prevent a regulated institution from requiring additional appraisal standards if deemed appropriate.

(Approved by the Office of Management and Budget under control number 3064-0103.)

[Codified to 12 C.F.R. § 323.4]

§ 323.5 Appraiser independence.

(a) *Staff appraisers.* If an appraisal is prepared by a staff appraiser, that appraiser must be independent of the lending, investment, and collection functions and not involved, except as an appraiser, in the federally related transaction, and have no direct or indirect interest, financial or otherwise, in the property. If the only qualified persons available to perform an appraisal are involved in the lending, investment, or collection functions of the regulated institution, the regulated institution shall take appropriate steps to ensure that the appraisers exercise independent judgment and that the appraisal is adequate. Such steps include, but are not limited to, prohibiting an individual from performing appraisals in connection with federally related transactions in which the appraiser is otherwise involved and prohibiting directors and officers from participating in any vote or approval involving assets on which they performed an appraisal.

(b) *Fee appraisers.* If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent and have no direct or indirect interest, financial or otherwise, in the property or transaction. A regulated institution may accept an appraisal that was prepared by an

appraiser engaged directly by another institution subject to title XI of FIRREA, if the regulated institution that accepts the appraisal has:

(1) Established procedures for review of real estate appraisals;

(2) Reviewed the appraisal under the established review procedures, finding the appraisal acceptable; and

(3) Documented the review in writing.

[Codified to 12 C.F.R. § 323.5]

§ 323.6 Professional association membership; competency.

(a) *Membership in appraisal organizations.* A state certified appraiser or a state licensed appraiser may not be excluded from consideration for an assignment for a federally related transaction solely by virtue of membership or lack of membership in any particular appraisal organization.

(b) *Competency.* All staff and fee appraisers performing appraisals in connection with federally related transactions must be state certified or licensed, as appropriate. However, a state certified or licensed appraiser may not be considered competent solely by virtue of being certified or licensed. Any determination of competency shall be based upon the individual's experience and educational background as they relate to the particular appraisal assignment for which he or she is being considered.

Appendix P

[Codified to 12 C.F.R. § 323.6]

§ 323.7 Enforcement.

Institutions and institution-affiliated parties, including staff appraisers and fee appraisers, may be subject to removal and/or prohibition orders, cease and desist orders, and the imposition of civil money penalties pursuant to the Federal Deposit Insurance Act, 12 U.S.C. 1811 *et seq.*, as amended, or other applicable law.

[Codified to 12 C.F.R. § 323.7]

Appendix A to Part 323: Excerpts from the Uniform Standards of Professional Appraisal Practice applicable to federally related transactions

(Based upon the Uniform Standards of Professional Appraisal Practice as promulgated by the Appraisal Standards Board of the Appraisal Foundation)[1]

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1. This document excludes portions of the Uniform Standards of Professional Appraisal Practice (USPAP) that are not applicable to federally related transactions. In addition, cross references to excluded provisions have been removed and additional text added for clarification only. The complete text of the USPAP is available from the Appraisal Foundation, 1029 Vermont Ave., N.W., Suite 900, Washington, DC 20005.

Appendix P

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Section I—Introduction

Preamble

It is essential that a professional appraiser arrive at and communicate his or her analyses, opinions, and advice in a manner that will be meaningful to the client and will not be misleading in the marketplace. These Uniform Standards of Professional Appraisal Practice reflect the current standards of the appraisal profession.

The importance of the role of the appraiser places ethical obligations on those who serve in this capacity. These standards include explanatory comments and begin with an Ethics Provision setting forth the requirements for integrity, objectivity, independent judgment, and ethical conduct. In addition, these standards include a Competency Provision which places an immediate responsibility on the appraiser prior to acceptance of an assignment. The standards contain binding requirements, as

well as specific guidelines. Definitions applicable to these standards are also included.

These standards deal with the procedures to be followed in performing an appraisal or review and the manner in which an appraisal or review is communicated. Standards 1 and 2 relate to the development and communication of a real property appraisal. Standard 3 establishes guidelines for reviewing an appraisal and reporting on that review.

These standards are for appraisers and the users of appraisal services. To maintain the highest level of professional practice, appraisers must observe these standards. The users of appraisal services should demand work performed in conformance with these standards.

Comment: Explanatory comments are an integral part of the Uniform Standards and should be viewed as extensions of the provisions, definitions, and standards rules. Comments provide interpretation from the Appraisal Standards Board concerning the background or application of certain provisions, definitions, or standards rules. There are no comments for provisions, definitions, and standards rules that are axiomatic or have not yet required further explanation; however, additional comments will be developed and others supplemented or revised as the need arises.

Ethics Provision

Because of the fiduciary responsibilities inherent in professional appraisal practice, the appraiser must observe the highest standards of professional ethics. This Ethics Provision is divided into four sections: conduct, management, confidentiality, and record keeping.

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Comment: This provision emphasizes the personal obligations and responsibilities of the individual appraiser. However, it should also be emphasized that groups and organizations engaged in appraisal practice share the same ethical obligations.

Conduct: An appraiser must perform ethically and competently in accordance with these standards and not engage in conduct that is unlawful, unethical, or improper. An appraiser who could reasonably be perceived to act as a disinterested third party in rendering an unbiased appraisal, review, or consulting service must perform assignments with impartiality, objectivity, and independence and without accommodation of personal interests.

Comment: An appraiser is required to avoid any action that could be considered misleading or fraudulent. In particular, it is unethical for an appraiser to use or communicate a misleading or fraudulent report or to knowingly permit an employee or other person to communicate a misleading or fraudulent report.

The development of an appraisal, review, or consulting service based on a hypothetical condition is unethical unless: 1) the use of the hypothesis is clearly disclosed; 2) the assumption of the hypothetical condition is clearly required for legal purposes, for purposes of reasonable analysis, or for purposes of comparison and would not be misleading; and 3) the report clearly describes the rationale for this assumption, the nature of the hypothetical condition, and its effect on the result of the appraisal, review or consulting service.

An individual appraiser employed by a group or organization which conducts itself in a manner that does not

conform to these standards should take steps that are appropriate under the circumstances to ensure compliance with the standards.

Management. The acceptance of compensation that is contingent upon the reporting of a predetermined value or a direction in value that favors the cause of the client, the amount of the value estimate, the attainment of a stipulated result, or the occurrence of a subsequent event is unethical.

The payment of undisclosed fees, commissions, or things of value in connection with the procurement of appraisal, review, or consulting assignments is unethical.

Comment: Disclosure of fees, commissions, or things of value connected to the procurement of an assignment should appear in the certification of a written report and in any transmittal letter in which conclusions are stated. In groups or organizations engaged in appraisal practice, intracompany payments to employees for business development are not considered to be unethical. Competency, rather than financial incentives, should be the primary basis for awarding an assignment.

Advertising for or soliciting appraisal assignments in a manner which is false, misleading or exaggerated is unethical.

Comment: In groups or organizations engaged in appraisal practice, decisions concerning finder or referral fees, contingent compensation, and advertising may not be the responsibility of an individual appraiser, but for a particular assignment, it is the responsibility of the individual appraiser to ascertain that there has been no breach of ethics, that the appraisal is prepared in accordance with these standards, and that the report can be properly certified as required by Standards rules 2-3 or 3-2.

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The restriction on contingent compensation in the first paragraph of this section does not apply to consulting assignments where the appraiser is not acting in a disinterested manner and would not reasonably be perceived as performing a service that requires impartiality. This permitted contingent compensation must be properly disclosed in the report.

Comment: The preparer of the written report of an assignment where the appraiser is not acting in a disinterested manner must certify that the compensation is contingent and must explain the basis for the contingency in the report, certification, executive summary and in any transmittal letter in which conclusions are stated.

Confidentiality. An appraiser must protect the confidential nature of the appraiser-client relationship.

Comment: An appraiser must not disclose confidential factual data obtained from a client or the results of an assignment prepared for a client to anyone other than: 1) the client and persons specifically authorized by the client; 2) such third parties as may be authorized by due process of law; and 3) a duly authorized professional peer review committee. As a corollary, it is unethical for a member of a duly authorized professional peer review committee to disclose confidential information or factual data presented to the committee.

Record Keeping. An appraiser must prepare written records of appraisal, review, and consulting assignments—including oral testimony and reports and retain such records for a period of at least five (5) years after preparation or at least two (2) years after final disposition of any judicial proceeding in which testimony was given, whichever period expires last.

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Comment: Written records of assignments include true copies of written reports, written summaries of oral testimony and reports (or a transcript of testimony), all data and statements required by these standards, and other information as may be required to support the findings and conclusions of the appraiser. The term written records also includes information stored on electronic, magnetic, or other media. Such records must be made available by the appraiser when required by due process of law or by a duly authorized professional peer review committee.

Competency Provision

Prior to accepting an assignment or entering into an agreement to perform any assignment, an appraiser must properly identify the problem to be addressed and have the knowledge and experience to complete the assignment competently; or alternatively:

1. Disclose the lack of knowledge and/or experience to the client before accepting the assignment; and

2. Take all steps necessary or appropriate to complete the assignment competently; and

3. Describe the lack of knowledge and/or experience and the steps taken to complete the assignment competently in the report.

Comment: The background and experience of appraisers varies widely and a lack of knowledge or experience can lead to inaccurate or inappropriate appraisal practice. The competency provision requires an appraiser to have both the knowledge and the experience required to perform a specific appraisal service

competently. If an appraiser is offered the opportunity to perform an appraisal service but lacks the necessary knowledge or experience to complete it competently, the appraiser must disclose his or her lack of knowledge or experience to the client before accepting the assignment and then take the necessary or appropriate steps to complete the appraisal service competently. This may be accomplished in various ways including, but not limited to, personal study by the appraiser; association with an appraiser reasonably believed to have the necessary knowledge or experience; or retention of others who possess the required knowledge or experience.

Although this provision requires an appraiser to identify the problem and disclose any deficiency in competence prior to accepting an assignment, facts or conditions uncovered during the course of an assignment could cause an appraiser to discover that he or she lacks the required knowledge or experience to complete the assignment competently. At the point of such discovery, the appraiser is obligated to notify the client and comply with items 2 and 3 of the provision.

The concept of competency also extends to appraisers who are requested or required to travel to geographic areas wherein they have no recent appraisal experience. An appraiser preparing an appraisal in an unfamiliar location must spend sufficient time to understand the nuances of the local market and the supply and demand factors relating to the specific property type and the location involved. Such understanding will not be imparted solely from a consideration of specific data such as demographics, costs, sales and rentals. The necessary understanding of local market conditions provides the bridge between a sale and a comparable sale or a rental and a comparable rental. If an appraiser is not in a position to spend the necessary

amount of time in a market area to obtain this understanding, affiliation with a qualified local appraiser may be the appropriate response to ensure the development of a competent appraisal.

Jurisdictional Exception[2]

If any part of these standards is contrary to the law or public policy of any jurisdiction, only that part shall be void and of no force or effect in that jurisdiction.

Supplemental Standards

These Uniform Standards provide the common basis for all appraisal practice. Supplemental standards applicable to appraisals prepared for specific purposes or property types may be issued by public agencies and certain client groups, e.g. regulatory agencies, eminent domain authorities, asset managers, and financial institutions. Appraisers and clients must ascertain whether any supplemental standards in addition to these Uniform Standards apply to the assignment being considered.

Definitions

For the purpose of these standards, the following definitions apply:

Appraisal: (noun) The act or process of estimating value; an estimate of value. (adjective) of or pertaining to appraising and related functions, e.g. appraisal practice, appraisal services.

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2. The Departure Provision that appears in the USPAP is not applicable to federally related transactions.

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Appraisal practice: The work or services performed by appraisers, defined by three terms in these standards: appraisal, review, and consulting.

Comment: These three terms are intentionally generic, and not mutually exclusive. For example, an estimate of value may be required as part of a review or consulting service. The use of other nomenclature by an appraiser (e.g. analysis, counseling, evaluation, study, submission, valuation) does not exempt an appraiser from adherence to these standards.

Cash Flow Analysis: A study of the anticipated movement of cash into or out of an investment.

Client: Any party for whom an appraiser performs a service.

Consulting: The act or process of providing information, analysis of real estate data, and recommendations or conclusions on diversified problems in real estate, other than estimating value.

Feasibility Analysis: A study of the cost benefit relationship of an economic endeavor.

Investment Analysis: A study that reflects the relationship between acquisition price and anticipated future benefits of a real estate investment.

Market Analysis: A study of real estate market conditions for a specific type of property.

Market Value: Market value is the major focus of most real

property appraisal assignments. Both economic and legal definitions of market value have been developed and refined.

A current economic definition agreed upon by federal financial institutions in the United States of America is:

The most probable price which a property should bring in a competitive and open market under all conditions requisite to a fair sale, the buyer and seller each acting prudently and knowledgeably, and assuming the price is not affected by undue stimulus. Implicit in this definition is the consummation of a sale as of a specified date and the passing of title from seller to buyer under conditions whereby:

1. Buyer and seller are typically motivated;

2. Both parties are well informed or well advised, and acting in what they consider their best interests;

3. A reasonable time is allowed for exposure in the open market;

4. Payment is made in terms of cash in United States dollars or in terms of financial arrangements comparable thereto; and

5. The price represents the normal consideration for the property sold unaffected by special or creative financing or sales concessions granted by anyone associated with the sale.

Substitution of another currency for *United States dollars* in the fourth condition is appropriate in countries or in reports addressed to clients from other countries.

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Persons performing appraisal services that may be subject to litigation are cautioned to seek the exact legal definition of market value in the jurisdiction in which the services are being performed.

Mass Appraisal: The process of valuing a universe of properties as of a given date utilizing standard methodology, employing common data, and allowing for statistical testing.

Mass Appraisal Model: A mathematical expression of how supply and demand factors interact in a market.

Personal Property: Identifiable portable and tangible objects which are considered by the general public as being "personal," e.g. furnishings, artwork, antiques, gems and jewelry, collectibles, machinery and equipment; all property that is not classified as real estate.

Real Estate: An identified parcel or tract of land, including improvements, if any.

Real Property: The interests, benefits, and rights inherent in the ownership of real estate.

Comment: In some jurisdictions, the terms "real estate" and "real property" have the same legal meaning. The separate definitions recognize the traditional distinction between the two concepts in appraisal theory.

Report: Any communication, written or oral, of an appraisal, review, or analysis; the document that is transmitted to the client upon completion of an assignment.

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Comment: Most reports are written and most clients mandate written reports. Oral report guidelines (See Standards rule 2-4) and restrictions (See Ethics Provision: Record Keeping) are included to cover court testimony and other oral communications of an appraisal, review or consulting service.

Review: The act or process of critically studying a report prepared by another.

Section II—Real Properly Appraisals

Standard 1

In developing a real property appraisal, an appraiser must be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal.

Comment: Standard 1 is directed toward the substantive aspects of developing a competent appraisal. The requirements set forth in Standards rule 1-1, the appraisal guidelines set forth in Standards rules 1-2, 1-3, 1-4, and the requirements set forth in Standards rule 1-5 mirror the appraisal process in the order of topics addressed and can be used by appraisers and the users of appraisal services as a convenient checklist.

Standards Rule 1-1. In developing a real property appraisal, an appraiser must:

(a) Be aware of, understand, and correctly employ those recognized methods and techniques that are necessary to produce a credible appraisal;

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Comment: Departure from this binding requirement is not permitted. This rule recognizes that the principle of change continues to affect the manner in which appraisers perform appraisal services. Changes and developments in the real estate field have a substantial impact on the appraisal profession. Important changes in the cost and manner of constructing and marketing commercial, industrial, and residential real estate and changes in the legal framework in which real property rights and interests are created, conveyed, and mortgaged have resulted in corresponding changes in appraisal theory and practice. Social change has also had an effect on appraisal theory and practice. To keep abreast of these changes and developments, the appraisal profession is constantly reviewing and revising appraisal methods and techniques and devising new methods and techniques to meet new circumstances. For this reason it is not sufficient for appraisers to simply maintain the skills and the knowledge they possess when they become appraisers. Each appraiser must continuously improve his or her skills to remain proficient in real property appraisal .

(b) Not commit a substantial error of omission or commission that significantly affects an appraisal;

Comment: Departure from this binding requirement is not permitted. In performing appraisal services an appraiser must be certain that the gathering of factual information is conducted in a manner that is sufficiently diligent to ensure that the data that would have a material or significant effect on the resulting opinions or conclusions are considered. Further, an appraiser must use sufficient care in analyzing such data to avoid errors that would significantly affect his or her opinions and conclusions.

(c) Not render appraisal services in a careless or negligent

manner, such as a series of errors that, considered individually, may not significantly affect the results of an appraisal, but which, when considered in the aggregate, would be misleading.

Comment: Departure from binding requirement is not permitted. Perfection is impossible to attain and competence does not require perfection. However, an appraiser must not render appraisal services in a careless or negligent manner. This rule requires an appraiser to use due diligence and due care. The fact that the carelessness or negligence of an appraiser has not caused an error that significantly affects his or her opinions or conclusions and thereby seriously harms a client or a third party does not excuse such carelessness or negligence.

Standards Rule 1-2. In developing a real property appraisal, an appraiser must observe the following specific appraisal guidelines:

(a) Adequately identify the real estate, identify the real property interest, consider the purpose and intended use of the appraisal, consider the extent of the data collection process, identify any special limiting conditions, and identify the effective date of the appraisal;

(b) Define the value being considered; if the value to be estimated is market value, the appraiser must clearly indicate whether the estimate is the most probable price:

(i) in terms of cash; or

(ii) in terms of financial arrangements equivalent to cash; or

(iii) in such other terms as may be precisely defined; if an

estimate of value is based on submarket financing or financing with unusual conditions or incentives, the terms of such financing must be clearly set forth, their contributions to or negative influence on value must be described and estimated, and the market data supporting the valuation estimate must be described and explained;

Comment: For certain types of appraisal assignments in which a legal definition of market value has been established and takes precedence, the Jurisdictional Exception may apply to this guideline.

If the concept of reasonable exposure in the open market is involved, the appraiser should be specific as to the estimate of marketing time linked to the value estimate.

(c) Consider easements, restrictions, encumbrances, leases, reservations, covenants, contracts, declarations, special assessments, ordinances, or other items of a similar nature;

(d) Consider whether an appraised fractional interest, physical segment, or partial holding contributes pro rata to the value of the whole;

Comment: This guideline does not require an appraiser to value the whole when the subject of the appraisal is a fractional interest, a physical segment, or a partial holding. However, if the value of the whole is not considered, the appraisal must clearly reflect that the value of the property being appraised cannot be used to estimate the value of the whole by mathematical extension.

(e) Identify and consider the effect on value of any personal

property, trade fixtures or intangible items that are not real property but are included in the appraisal.

Comment: This guideline requires the appraiser to recognize the inclusion of items that are not real property in an overall value estimate. Additional expertise in personal property or business appraisal may be required to allocate the overall value to its various components. Separate valuation of such items is required when they are significant to the overall value.

Standards Rule 1-3. In developing a real property appraisal, an appraiser must observe the following specific appraisal guidelines:

(a) Consider the effect on use and value of the following factors: existing land use regulations, reasonably probable modifications of such land use regulations, economic demand, the physical adaptability of the real estate, neighborhood trends, and the highest and best use of the real estate;

Comment: This guideline sets forth a list of factors that affect use and value. In considering neighborhood trends, an appraiser must avoid stereotyped or biased assumptions relating to race, age, color, religion, gender, or national origin or an assumption that racial, ethnic, or religious homogeneity is necessary to maximize value in a neighborhood. Further, an appraiser must avoid making an unsupported assumption or premise about neighborhood decline, effective age, and remaining life. In considering highest and best use, an appraiser should develop the concept to the extent that is required for a proper solution of the appraisal problem being considered.

(b) Recognize that land is appraised as though vacant and

available for development to its highest and best use and that the appraisal of improvements is based on their actual contributions to the site.

Comment: This guideline may be modified to reflect the fact that, in various legal and practical situations, a site may have a contributory value that differs from the value as if vacant.

Standards Rule 1-4. In developing a real property appraisal, an appraiser must observe the following specific appraisal guidelines, when applicable:

(a) Value the site by an appropriate appraisal method or technique;

(b) Collect, verify, analyze, and reconcile:

(i) such comparable cost data as are available to estimate the cost new of the improvements (if any);

(ii) such comparable data as are available to estimate the difference between cost new and the present worth of the improvements (accrued depreciation);

(iii) such comparable sales data, adequately identified and described, as are available to indicate a value conclusion;

(iv) such comparable rental data as are available to estimate the market rental of the property being appraised;

(v) such comparable operating expense data as are available to estimate the operating expenses of the property being appraised;

(vi) such comparable data as are available to estimate rates of capitalization and/or rates of discount.

Comment: This rule covers the three approaches to value. See Standards rule 2-2(j) for corresponding reporting requirements.

(c) Base projections of future rent and expenses on reasonably clear and appropriate evidence;

Comment: This guideline requires an appraiser, in developing income and expense statements and cash now projections, to weigh historical information and trends, current market factors affecting such trends, and anticipated events such as competition from developments under construction.

(d) When estimating the value of a leased fee estate or a leasehold estate, consider and analyze the effect on value, if any, of the terms and conditions of the lease(s);

Consider and analyze the effect on value, if any, of the assemblage of the various estates or component parts of a property and refrain from estimating the value of the whole solely by adding together the individual values of the various estates or component parts;

Comment: Although the value of the whole may be equal to the sum of the separate estates or parts, it also may be greater than or less than the sum of such estates or parts. Therefore, the value of the whole must be tested by reference to appropriate market data and supported by an appropriate analysis of such data.

A similar procedure must be followed when the value of the

whole has been established and the appraiser seeks to estimate the value of a part. The value of any such part must be tested by reference to appropriate market data and supported by an appropriate analysis of such data.

(f) Consider and analyze the effect on value, if any, of anticipated public or private improvements, located on or off the site, to the extent that market actions reflect such anticipated improvements as of the effective appraisal date;

Comment: In condemnation valuation assignments in certain jurisdictions, the Jurisdictional Exception may apply to this guideline.

(g) Identify and consider the appropriate procedures and market information required to perform the appraisal, including all physical, functional, and external market factors as they may affect the appraisal;

Comment: The appraisal may require a complete market analysis.

(h) Appraise proposed improvements only after examining and having available for future examination:

(i) plans, specifications, or other documentation sufficient to identify the scope and character of the proposed improvements;

(ii) evidence indicating the probable time of completion of the proposed improvements; and

(iii) Reasonably clear and appropriate evidence supporting

development costs, anticipated earnings, occupancy projections, and the anticipated competition at the time of completion.

Comment: The evidence required to be examined and maintained under this guideline may include such items as contractor's estimates relating to cost and the time required to complete construction, market, and feasibility studies; operating cost data; and the history of recently completed similar developments. The appraisal may require a complete feasibility analysis.

(i) All pertinent information in items (a) through (h) above shall be used in the development of an appraisal.

Comment: See standards rule 2-2(k) for corresponding reporting requirements.

Standards Rule 1-5. In developing a real property appraisal, an appraiser must:

(a) Consider and analyze any current Agreement of Sale, option, or listing of the property being appraised, if such information is available to the appraiser in the normal course of business;

(b) Consider and analyze any prior sales of the property being appraised that occurred within the following time periods:

(i) one year for one-to-four family residential property; and

(ii) three years for all other property types;

Comment: The intent of this requirement is to encourage the

research and analysis of prior sales of the subject; the time frames cited are minimum.

(c) Consider and reconcile the quality and quantity of data available and analyzed within the approaches used and the applicability or suitability of the approaches used.

Comment: Departure from this binding requirement is not permitted. See Standards rule 2-2 (k) comment for corresponding reporting requirements.

Standard 2

In reporting the results of a real property appraisal an appraiser must communicate each analysis, opinion, and conclusion in a manner that is not misleading.

Comment: Standard 2 governs the form and content of the report that communicates the results of an appraisal to a client and third parties.

Standards Rule 2-1. Each written or oral real property appraisal report must:

(a) Clearly and accurately set forth the appraisal in a manner that will not be misleading;

Comment: Departure from this binding requirement is not permitted. Since most reports are used and relied upon by third parties, communications considered adequate by the appraiser's client may not be sufficient. An appraiser must take extreme care to make certain that his or her reports will not be misleading in the marketplace or to the public.

(b) Contain sufficient information to enable the person(s) who receive or rely on the report to understand it properly;

Comment: Departure from this binding requirement is not permitted. A failure to observe this rule could cause a client or other users of the report to make a serious error even though each analysis, opinion, and conclusion in the report is clearly and accurately stated. To avoid this problem and the dangers it presents to clients and other users of reports, this rule requires an appraiser to include in each report sufficient information to enable the reader to understand it properly. All reports, both written and oral, must clearly and accurately present the analyses, opinions, and conclusions of the appraiser in sufficient depth and detail to address adequately the significance of the specific appraisal problem.

(c) Clearly and accurately disclose any extraordinary assumption or limiting condition that directly affects the appraisal and indicate its impact on value.

Comment: Departure from this binding requirement is not permitted. Examples of extraordinary assumptions or conditions might include items such as the execution of a pending lease agreement, atypical financing, or completion of onsite or offsite improvements. In a written report the disclosure would be required in conjunction with statements of each opinion or conclusion that is affected.

Standards Rule 2-2. Each written real property appraisal report must:

(a) Identify and describe the real estate being appraised;

(b) Identify the real property interest being appraised;

Comment on (a) and (b): These two requirements are essential elements in any report. Identifying the real estate can be accomplished by any combination of a legal description, address, map reference, copy of a survey or map, property sketch and/or photographs. A property sketch and photographs also provide some description of the real estate in addition to written comments about the physical attributes of the real estate. Identifying the real property rights being appraised requires a direct statement substantiated as needed by copies or summaries of legal descriptions or other documents setting forth any encumbrances.

(c) State the purpose of the appraisal;

(d) Define the value to be estimated;

(e) Set forth the effective date of the appraisal and the date of the report;

Comment on (c), (d) and (e): These three requirements call for clear disclosure to the reader of a report the "why, what and when" surrounding the appraisal. The purpose of the appraisal is used generically to include both the task involved and rationale for the appraisal. Defining the value to be estimated requires both an appropriately referenced definition and any comments needed to clearly indicate to the reader how the definition is being applied [See standards rule 1-2(b)]. The effective date of the appraisal establishes the context for the value estimate, while the date of the report indicates whether the perspective of the appraiser on the market conditions as of the effective date of the appraisal was prospective, current, or retrospective. Reiteration

of the date of the report and the effective date of the appraisal at various stages of the report in tandem is important for the clear understanding of the reader whenever market conditions on the date of the report are different from market conditions on the effective date of the appraisal.

(f) Describe the extent of the process of collecting, confirming, and reporting data;

Comment: This requirement is designed to protect third parties whose reliance on an appraisal report may be affected by the extent of the appraiser's investigation; i.e., the process of collecting, confirming and reporting data.

(g) Set forth all assumptions and limiting conditions that affect the analyses, opinions, and conclusions;

Comment: It is suggested that assumptions and limiting conditions be grouped together in an identified section of the report.

(h) Set forth the information considered, the appraisal procedures followed, and the reasoning that supports the analyses, opinions, and conclusions;

Comment: This requirement calls for the appraiser to summarize the data considered and the procedures that were followed. Each item must be addressed in the depth and detail required by its significance to the appraisal. The appraiser must be certain that sufficient information is provided so that the client, the users of the report, and the public will understand it and will not be misled or confused. The substantive content of the report, not its size, determines its compliance with this specific reporting guideline.

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(i) Set forth the appraiser's opinion of the highest and best use of the real estate, when such an opinion is necessary and appropriate;

Comment: This requirement calls for a written report to contain a statement of the appraiser's opinion as to the highest and best use of the real estate, unless an opinion as to highest and best use is unnecessary, e.g. insurance valuation or value in use appraisals. If an opinion as to highest and best use is required, the reasoning in support of the opinion must also be included.

(j) Explain and support the exclusion of any of the usual valuation approaches;

(k) Set forth any additional information that may be appropriate to show compliance with, or clearly identify and explain permitted departures from, the requirements of standard 1;

Comment: This requirement calls for a written appraisal report or other written communication concerning the results of an appraisal to contain sufficient information to indicate that the appraiser complied with the requirements of standard 1, including the requirements governing any permitted departures from the appraisal guidelines. The amount of detail required will vary with the significance of the information to the appraisal.

Information considered and analyzed in compliance with Standards rule 1-5 is significant information that deserves comment in any report. If such information is unobtainable, comment on the efforts undertaken by the appraiser to obtain the information is required.

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(1) Include a signed certification in accordance with Standards rule 2-3.

Comment: Departure from binding requirements (a) through (l) above is not permitted.

Standards Rule 2-3. Each written real property appraisal report must contain a certification that is similar in content to the following form:

I certify that, to the best of my knowledge and belief:

— The statements of fact contained in this report are true and correct.

— The reported analyses, opinions, and conclusions are limited only by the reported assumptions and limiting conditions, and are my personal, unbiased professional analyses, opinions, and conclusions.

— I have no (or the specified) present or prospective interest in the property that is the subject of this report, and I have no (or the specified) personal interest or bias with respect to the parties involved.

— My compensation is not contingent upon the reporting of a predetermined value or direction in value that favors the cause of the client, the amount of the value estimate, the attainment of a stipulated result, or the occurrence of a subsequent event.

— My analyses, opinions, and conclusions were developed, and this report has been prepared, in

conformity with the Uniform Standards of Professional Appraisal Practice.

— I have (or have not) made a personal inspection of the property that is the subject of this report. (If more than one person signs the report, this certification must clearly specify which individuals did and which individuals did not make a personal inspection of the appraised property.)

— No one provided significant professional assistance to the person signing this report. (If there are exceptions, the name of each individual providing significant professional assistance must be stated.)

Comment: Departure from this binding requirement is not permitted.

Standards Rule 2-4. To the extent that it is both possible and appropriate, each oral real property appraisal report (including expert testimony) must address the substantive matters set forth in Standards rule 2-2.

Comment: In addition to complying with the requirements of Standards rule 2-1, an appraiser making an oral report must use his or her best efforts to address each of the substantive matters in Standards rule 2-2. Testimony of an appraiser concerning his or her analyses, opinions, and conclusions is an oral report in which the appraiser must comply with the requirements of this Standards rule.

See *Record Keeping* under the **ETHICS PROVISION** for corresponding requirements.

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Standards Rule 2-5. An appraiser who signs a real property appraisal report prepared by another, even under the label of "review appraiser", must accept full responsibility for the contents of the report.

Comment: Departure from this binding requirement is not permitted. This requirement is directed to the employer or supervisor signing the report of an employee or subcontractor. The employer or supervisor signing the report is as responsible as the individual preparing the appraisal for the content and conclusions of the appraisal and the report. Using a conditional label next to the signature of the employer or supervisor or signing a form report on the line over the words "review appraiser" does not exempt that individual from adherence to these standards.

This requirement does not address the responsibilities of a review appraiser, the subject of standard 3.

Section III — Review appraisals

Standard 3

In reviewing an appraisal and reporting the results of that review, an appraiser must form an opinion as to the adequacy and appropriateness of the report being reviewed and must clearly disclose the nature of the review process undertaken.

Comment: The function of reviewing an appraisal requires the preparation of a separate report or a file memorandum by the appraiser performing the review setting forth the results of the review process. Review appraisers go beyond checking for a level of completeness and consistency in the report under review

by providing comment on the content and conclusions of the report. They may or may not have first-hand knowledge of the subject property or of data in the report. The COMPETENCY PROVISION applies to the appraiser performing the review as well as the appraiser who prepared the report under review.

Reviewing is a distinctly different function from that addressed in Standards rule 2-5. To avoid confusion in the marketplace between these two functions, review appraisers should not sign the report under review unless they intend to take the responsibility of a cosigner.

Review appraisers must take appropriate steps to indicate to third parties the precise extent of the review process. A separate report or letter is one method. Another appropriate method is a form or checklist prepared and signed by the appraiser conducting the review and attached to the report under review. It is also possible that a stamped impression on the appraisal report under review, signed or initialed by the reviewing appraiser, may be an appropriate method for separating the review function from the actual signing of the report. To be effective, however, the stamp must briefly indicate the extent of the review process and refer to a file memorandum that clearly outlines the review process conducted.

The review appraiser must exercise extreme care in clearly distinguishing between the review process and the appraisal or consulting processes. Original work by the review appraiser may be governed by STANDARD 1 rather than this standard. A misleading or fraudulent review and/or report violates the ETHICS PROVISION.

Standards Rule 3-1 In reviewing an appraisal, an appraiser must:

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(a) Identify the report under review, the real estate and real property interest being appraised, the effective date of the opinion in the report under review, and the date of the review;

(b) Identify the extent of the review process to be conducted;

(c) Form an opinion as to the completeness of the report under review in light of the requirements in these standards;

Comment: The review should be conducted in the context of market conditions as of the effective date of the opinion in the report being reviewed.

(d) Form an opinion as to the apparent adequacy and relevance of the data and the propriety of any adjustments to the data;

(e) Form an opinion as to the appropriateness of the appraisal methods and techniques used and develop the reasons for any disagreement;

(f) Form an opinion as to whether the analyses, opinions, and conclusions in the report under review are appropriate and reasonable, and develop the reasons for any disagreement.

Comment: Departure from binding requirements (a) through (f) above is not permitted. An opinion of a different estimate of value from that in the report under review may be expressed, provided the review appraiser:

1. Satisfies the requirements of STANDARD 1;

2. Identifies and sets forth any additional data relied upon and the reasoning and basis for the different estimate of value; and,

3. Clearly identifies and discloses all assumptions and limitations connected with the different estimate of value to avoid confusion in the marketplace.

Standards Rule 3-2. In reporting the results of an appraisal review, an appraiser must:

(a) Disclose the nature, extent, and detail of the review process undertaken;

(b) Disclose the information that must be considered in Standards rule 3-1 (a) and (b);

(c) Set forth the opinions, reasons, and conclusions required in Standards rule 3-1 (c), (d), (e) and (f);

(d) Include all known pertinent information;

(e) Include a signed certification similar in content to the following:

I certify that, to the best of my knowledge and belief:

— The facts and data reported by the review appraiser and used in the review process are true and correct.

— The analyses, opinions, and conclusions in this review report are limited only by the assumptions and limiting conditions stated in this review report, and are my

personal, unbiased professional analyses, opinions and conclusions.

— I have no (or the specified) present or prospective interest in the property that is the subject of this report and I have no (or the specified) personal interest or bias with respect to the parties involved.

— My compensation is not contingent on an action or event resulting from the analyses, opinions, or conclusions in, or the use of, this review report.

— My analyses, opinions, and conclusions were developed and this review report was prepared in conformity with the Uniform Standards of Professional Appraisal Practice.

— I did not (did) personally inspect the subject property of the report under review.

— No one provided significant professional assistance to the person signing this review report. (If there are exceptions, the name of each individual providing significant professional assistance must be stated.)

Comment: Departure from binding requirements (a) through (e) above is not permitted.

[Codified to 12 C.F.R. Part 323, Appendix A]

[Appendix A added at 55 Fed. Reg. . 3612, December 31, 1990, effective January 30, 1991]

APPENDIX Q — REAL ESTATE LOANS - APPRAISALS - REVISED FFIEC GUIDELINES, JULY 11, 1991

REAL ESTATE LOANS

[¶ 88,548] Depository Institutions Notified of Revised Appraisal Guidelines

Federal Financial Institutions Council. FIL-35-91. July 11, 1991. Letter in full text.

Real Estate Loans — Appraisals — Revised FFIEC Guidelines — The Appraisal Subcommittee of the Federal Financial Institutions Examination Council has notified depository institutions of the revised guidelines regarding state certification and licensing of appraisers. The revised guidelines were designed to help the States, Territories and the District of Columbia in establishing effective certification and licensing procedures for real estate appraisers involved in federally related transactions under Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

Back reference: ¶ 66,037A.

[FIL]

On May 29, 1991, the Appraisal Subcommittee of the Federal Financial Institutions Examination Council ("ASC") adopted Revised Guidelines Regarding State Certification and Licensing of Appraisers ("Revised Guidelines"). The Revised Guidelines are designed to help the States, Territories and the District of Columbia in establishing effective certification and licensing procedures for real estate appraisers involved in federally related transactions under Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

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State certified or licensed appraisers generally must be used for federally related transactions beginning January 1, 1992.

The Revised Guidelines include changes based on comments received on their original publication on January 24, 1990 (55 F.R. 2409) and incorporate subsequent ASC advisories, opinions, and clarification. Publication of the Revised Guidelines in the Federal Register is expected during the week ending June 7, 1991. [The revised guidelines are reproduced at ¶66,037A.]

Distribution: Insured Banks and Savings Associations

APPENDIX R — FDIC FINAL REVISIONS TO REAL ESTATE APPRAISAL REGULATIONS, JUNE 8, 1994

FDIC
Federal Deposit Insurance Corporation **Office of the Director**
Washington, DC 20429 **Division of Supervision**

FIL-41-94
June 8, 1994

REAL ESTATE APPRAISALS

To: CHIEF EXECUTIVE OFFICER

Subject: *Final Revisions to Real Estate Appraisal Regulations*

The four federal regulators of banks and thrifts have jointly agreed to new rules on real estate appraisals that are intended to reduce costs and encourage lending without diminishing safe and sound banking practices. A copy of the final rules is attached.

The revised rules include provisions that:

- Increase the threshold level to $250,000, from $100,000, for loans that require a real estate appraisal by a certified or licensed appraiser;

- Exempt from the appraisal requirements business loans of $1 million or less where the sale or rental of real estate is not the primary source of repayment;

- Expand and clarify other exemptions from appraisal requirements, such as those for renewals of existing loans, certain loan purposes, certain transactions where real estate is taken as additional collateral in an

"abundance of caution" by the lender, and loans that qualify for sale or are guaranteed by a U.S. government agency or government-sponsored agency; and

- Reduce and simplify the standards for conducting required appraisals, relying more on industry standards.

The new rules went into effect when they were published in the *Federal Register* on June 7, 1994. For more information, please contact your Division of Supervision regional office.

s/ Stanley J. Poling
Stanley J. Poling
Director

Attachment

FDIC-Supervised Banks (Commercial and Savings)

Appendix R

DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

12 CFR Part 34

[Docket No. 94-10]

RIN 1557-AB34

FEDERAL RESERVE SYSTEM

12 CFR Part 225

[Regulation Y; Docket No. R-0803]

RIN 7100-AB20

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Part 323

RIN 3064-ABO5

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

12 CFR Parts 545, 563, 564

[Docket No. 94-47]

RIN 1550-AA64

Appendix R

Real Estate Appraisals

AGENCIES: Office of the Comptroller of the Currency, Treasury; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; and Office of Thrift Supervision, Treasury.

ACTION: Final rule.

SUMMARY: The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively the agencies) are amending their regulations regarding appraisals of real estate. This final rule is adopted pursuant to Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

The final rule increases to $250,000 the threshold at or below which appraisals are not required pursuant to Title XI, expands and clarifies existing exemptions to the Title XI appraisal requirement, identifies additional circumstances when appraisals are not required under Title XI, and specifies when exempt transactions nevertheless require appropriate evaluations. In addition, the final rule amends existing requirements governing appraisal content and the use of appraisals prepared by other financial services institutions.

The agencies are adopting this final rule to further federal financial and public policy interests by reducing regulatory burden, while requiring Title XI appraisals when necessary to protect the safety and soundness of financial institutions or otherwise advance public policy.

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EFFECTIVE DATE: This final rule is effective on June 7,1994.

FOR FURTHER INFORMATION CONTACT:

Office of the Comptroller of the Currency (*OCC*)

Thomas E. Watson, National Bank Examiner, Office of the Chief National Bank Examiner, (202) 874-5170; or Horace G. Sneed, Senior Attorney, or Stephen Freeland, Attorney, (202) 874-4460, Bank Operations and Assets Division; Office of the Comptroller of the Currency, 250 E Street, SW, Washington, DC 20219.

Board of Governors of the Federal Reselve System (Board)

Roger T. Cole, Deputy Associate Director, (202) 452-2618, Rohger H. Pugh, Assistant Director, (202) 728-5883, Stanley B. Rediger, Supervisory Financial Analyst (202) 452-2629, or Virginia M. Gibbs, Supervisory Financial Analyst, (202) 452-2521, Division of Banking Supervision and Regulation; or Gregory A. Baer, Senior Attorney (202) 452-3236, Legal Division; Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551.

Federal Deposit Insurance Corporation (FDIC)

Robert F. Miailovich, Associate Director, (202) 898-6918, James D. Leitner, Examination Specialist, (202) 898-6790, Division of Supervision; or Walter P. Doyle, Counsel, (202) 898-3682, Legal Division; Federal Deposit Insurance Corporation, 550 17th Street NW., Washington, DC 20429.

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Office of Thrift Supervision (OTS)

Robert Fishman, Senior Program Manager, Credit Risk, Supervision Policy, (202) 906-5672; Deirdre G. Kvartunas, Policy Analyst, Supervision Policy, (202) 906-7933; Ellen J. Sazzman, Counsel (Banking and Finance), Regulations and Legislation Division, Chief Counsel's Office, (202) 906-7133; Office of Thrift Supervision, 1700 G Street NW., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

1. Background

Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), 12 U.S.C. 3331 *et seq.*, directs each Federal banking agency to publish appraisal regulations for federally related transactions within its jurisdiction. The purpose of the legislation is to protect federal financial and public policy interests in real estate related transactions by requiring that real estate appraisals utilized in connection with federally related transactions are performed in writing, in accordance with uniform standards, and by individuals whose competency has been demonstrated and whose professional conduct will be subject to effective supervision. See 12 U.S.C. 3331.

Section 1121(4) of FIRREA, 12 U.S.C. 3350(4), defines a federally related transaction as a real estate-related financial transaction that is regulated or engaged in by a federal financial institutions regulatory agency and requires the services of an appraiser. A real estate-related financial transaction is defined as any transaction that involves:

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(i) The sale, lease, purchase, investment in or exchange of real property, including interests in property, or the financing thereof;

(ii) The refinancing of real property or interests in real property; and

(iii) The use of real property or interests in real property as security for a loan or investment, including mortgage-backed securities. See 12 U.S.C. 3350(5) (FIRREA section 1121(5)).

In their appraisal regulations, the agencies identify categories of real estate-related financial transactions that do not require the services of an appraiser in order to protect federal financial and public policy interests or to satisfy principles of safe and sound banking. These real estate-related financial transactions are not federally related transactions under the statutory and regulatory definitions. Accordingly, they are subject to neither Title XI of FIRREA nor those provisions of the agencies' regulations governing appraisals.

In December 1992, Congress confirmed that the agencies may set a threshold level below which the services of state certified or licensed appraisers are not required in connection with federally related transactions if the agencies determine in writing that the threshold does not represent a threat to the safety and soundness of financial institutions. See Housing and Community Development Act of 1992, Public Law 102-550, section 954 (amending 12 U.S.C. 3341).

The agencies jointly published a proposed rule to amend their appraisal regulations on June 4, 1993. See 58 FR 31878. The agencies published a notice of the availability of supplemental

information concerning the proposed rule and invited further comments on November 10, 1993. See 58 FR 59688.

The agencies are issuing this joint final rule under their authority to issue rules to implement Title XI of FIRREA and each agency's authority to prescribe rules and regulations to carry out its responsibility to ensure that the institutions under its supervision conduct their activities in accordance with safe and sound banking principles. This final rule is intended to protect federal financial and public policy interests and the safety and soundness of financial institutions, while reducing duplication, costs and regulatory burden.

II. Comments on the Proposed Rule

A. Overview of Comments

Collectively, the agencies received over 19,000 comment letters on the proposed rule. In response to the June 4th Notice of Proposed Rulemaking, the agencies received comment letters from appraisers, bankers, and others as shown in Table A. Comment letters received in response to the November 10th Notice of Supplemental Information were distributed as shown in Table B.

Table A.—Distribution of Comments Received in Response to June 4, 1993 Proposed Rule

Agency	Letters from appraisers	Letters from bankers	Letters from others	Total
OCC	1660	161	168	1989
Board	1608	259	276	2143
FDIC	1574	376	149	2099
OTS	1298	40 (14 thrifts)	134	1472

Table B.—Distribution of Comments Received in Response to November 10, 1993 Notice of Supplemental Information

Agency	Letters from appraisers	Letters from bankers	Letters from others	Total
OCC	1878	659	242	2779
Board	1994	519	528	3041
FDIC	1818	1142	467	3427
OTS	1644	57 (22 thrifts)	502	2203

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The agencies have reviewed and considered all comments concerning the proposed rule. The agencies discuss general comments immediately below. Responses to the agencies' specific requests for comment and comments concerning specific amendments to the appraisal regulation are discussed in the section-by-section analysis.

B. General Comments on the Proposed Rule

Regulated institutions generally endorsed the proposed changes to the appraisal regulations, though a small number of savings associations, banks, and other commenters opposed changing the regulation. Appraisers almost unanimously opposed changing the threshold, and a large number of appraisers opposed the business loan exemption. However, appraisers commented favorably on other parts of the proposed rule.

A large number of appraisers commented that the proposed changes would lead to abuses that caused savings associations to fail in the mid-to-late 1980s and that the changes would violate the intent of Congress. In the experience of the agencies, and in the opinion of studies conducted on the failures of the 1980s, abuses were related to real estate acquisition or development projects and larger loans. The regulations issued today continue to require appraisals for these transactions. Moreover, the regulations fully comply with the intent of Congress by continuing to protect federal financial and public policy interests in real estate-related financial transactions as well as the safety and soundness of financial institutions.

Regulated institutions and appraisers have over three years experience with the appraisal regulations and have urged changes in the regulations to improve credit availability and reduce

duplication, costs, and regulatory burden. Some commenters, focusing on the proposed threshold, opposed changing the regulations because they believed that additional time was needed to study the effect of the existing regulations. Delaying the issuance of the final rule would deny regulated institutions, appraisers, and borrowers the benefits of these changes. To the extent that subsequent events demonstrate that additional changes are needed, the agencies can further amend the regulations.

One appraisal organization suggested that several of the proposed exemptions should be replaced with guidelines regarding when to obtain Title XI appraisals. Because regulated institutions and appraisers can become liable for substantial penalties for violating the regulation, the agencies believe that it benefits regulated institutions, appraisers, and the public for the agencies to identify categories of exempt transactions in the regulation. However, the agencies intend to provide supplemental information about the appraisal and evaluation practices of regulated institutions in guidance.

Some commenters stated that they were denied an opportunity to comment on the supplemental information identified in the November 10th notice because the materials were available only in Washington, DC, and the comment period was 30 days. The agencies believe that the public procedures on the proposed amendments to the appraisal regulations fully complied with the requirements of the Administrative Procedure Act and accorded the public a full opportunity to participate in the rulemaking.

The November 10th notice explained that the supplemental materials were available from each of the agencies. In accordance

with established procedures, all agencies mailed copies of those materials to any person requesting them, as well as having the documents available for review at each agency.

The agencies also believe the 30-day comment period was appropriate for the second comment period on the proposed amendments. The notice of supplemental information requested comment on materials that dealt almost exclusively with the appraisal threshold. As shown in Table B above, more than 11,000 comment letters were received in response to the November 10th notice.

III. Section-by-Section Analysis

§ ____.2 Definitions.

(d) Business Loan

The agencies are adopting the proposed definition of "business loan" as a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship (including an individual engaged in farming), or other business entity. The definition is used in connection with the exemption for business loans of $1 million or less that are not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.

Commenters suggested that the agencies amend the definition of business loan to include loans to individuals for business purposes and to permit use of the exemption when individuals lease real estate to a related business. Loans to individuals are included in the definition of business loan as loans

to sole proprietorship and other business entities. This exemption does not apply to loans to individuals that are consumer or personal loans. Therefore, the agencies do not believe that it is necessary to amend the definition.

(h) Real Estate or Real Property

The Board is adding a definition of "real estate" and "real property" to § 225.62 of its regulation. The Board proposed this amendment to incorporate the definition of real estate and real property employed by the other agencies. That definition specifically excludes mineral rights, timber rights, growing crops, water rights, and similar interests.

Title XI of FIRREA does not define "real estate" or "real property" nor does the context in which these terms are used suggest that the terms are intended to have different technical meanings. See 55 FR 27762 (July 5, 1990).

The Board used "real property" and "real estate" interchangeably throughout its appraisal rule to mean interests in an identified parcel or tract of land and improvements. However, the Board did not intend these terms to include mineral rights, timber rights, or growing crops when they are considered separately from the parcel or tract of land. Valuation of such interests generally requires the services of a professional other than a real estate appraiser.

To clarify this distinction, the Board has amended its regulation to define "real property" and "real estate" for purposes of the appraisal regulation as an identified parcel or tract of land, including improvements, easements, rights of way, undivided or future interests and similar rights in a tract of land, but excluding mineral rights, timber rights, or growing crops.

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Few commenters expressed an opinion on this proposed change. Those few commenters who opposed the definition stated that timber and growing crops should not be excluded from the definition of real estate in that the value of such items is tied to the value of the land. Comments opposing this definition were generally from appraisers who perform farm and timber appraisals.

In many states, minerals, timber, and growing crops that have not been severed from the land are considered interests in real estate or real property. Consequently, if mineral rights are collateral for a loan in one of those states, a question arises whether the institution must obtain a real estate appraisal of the parcel or tract of land to which the mineral rights are attached but in which the institution has no interest.

The Board's final rule clarifies that regulated institutions are not required to obtain appraisals of the parcel of land to which mineral rights, or similar severable interests in real estate are attached, if the transaction only involves the severable interest rather than the parcel or tract of land. Where mineral rights, timber rights, or growing crops, *and* the associated parcel or tract of land, are the subject of a real estate-related financial transaction, the services of a licensed or certified appraiser would be required unless the transaction is otherwise exempt.

In addition, the contribution of relevant mineral rights, timber rights, or growing crops should be included when appraising a parcel of land which possesses any of these features. However, valuation of these interests would not be required if they are not part of the transaction or if they are not relevant to the analyses which the appraiser needs to perform to arrive at an estimate of value far the parcel or tract of land.

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§ __.3(a) Appraisals required

(1) Threshold

The agencies proposed an increase from $100,000 to $250,000 in the threshold at or below which a Title XI appraisal is not required, and specifically asked commenters whether a $250,000 or some other threshold would be appropriate. In addition, the agencies requested information on loss experience of depository institutions for loans greater than $250,000 and loans of $250,000 or less. On November 10, 1993, the agencies made available supplemental information on the proposed rule and extended the comment period for 30 days in order to allow commenters to consider and comment on the information. The supplemental information related primarily to the proposed increase in the threshold.

A majority of the commenters addressed the threshold issue. Almost all of the commenters opposed to the increase were appraisers, while almost all of the commenters in favor of the increase were depository institutions.

Most of those opposed stated as the basis for their opposition that an increase in the threshold would cause substantial losses for depository institutions, and thereby for the deposit insurance funds. To support this view, commenters generally cited the thrift failures of the 1980s and asserted that an increase in the threshold would lead to the same result.

A total of 74 comment letters provided data on loss experience. The institutions providing the data varied in size, and included large regional multibank holding companies, as well as small banks. This data is discussed below.

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For the reasons set forth below, the agencies have decided to raise the threshold from $100,000 to $250,000. Such an increase will benefit consumers and lenders and will not threaten the safety and soundness of financial institutions, particularly as an evaluation will be required for all loans exempt under the threshold.

Benefits for Consumers and Lenders of an Increase in the Threshold. Many commenters stated that an increase in the threshold would benefit consumers and lenders. Numerous bank and thrift commenters pointed to the cost and time needed in order to obtain an appraisal as an impediment to lending. The appraisal was cited by several commenters as the most important factor causing delay in small business lending, and the cost of the appraisal was described as high, especially for commercial borrowers. Commenters reported that appraisal fees for commercial transactions between $100,000 and $250,000 could cost 5 percent of the loan amount to the borrower. Banks and thrifts also commented that increasing the threshold would reduce regulatory burden associated with making loans below $250,000. Many appraisers, however, commented that appraisal costs have remained relatively steady.

Many appraisers also stated that appraisals by certified or licensed appraisers are necessary to protect the consumer. The agencies believe that this assertion mischaracterizes the role of the institution's determination of collateral value in a typical consumer transaction. The regulated institution obtains the appraisal or evaluation as part of its loan underwriting process in order to make certain that it is adequately secured. Any appraisal ordered by a financial institution is not designed, and generally comes too late, to assist the consumer in negotiating a contract price. In a purchase of real estate, the purchase offer is generally made before financing is sought and the financial institution

orders an appraisal. Therefore, the appraisal represents an after-the-fact cost. Further, even when a Title XI appraisal is not required, nothing prevents a consumer from independently obtaining an appraisal by a licensed or certified appraiser for the consumer's own use in the negotiating process. Moreover, the agencies' rules require an institution to obtain an appropriate evaluation of the real property collateral for transactions below the threshold, and that evaluation would be available to the consumer. The agencies believe that many of the concerns about consumer protection are addressed under statutory and regulatory programs other than Title XI of FIRREA, which focuses on bank and thrift safety and soundness.

The Real Estate Settlement Procedures Act (RESPA) establishes procedures for lenders to disclose to consumers the charges for a variety of settlement services, including appraisals and evaluations. To comply with the letter and intent of the Board's Regulation B (implementing the Equal Credit Opportunity Act), regulated institutions must either disclose to the borrower the right to receive a copy of the documents the lender uses to value the collateral in an application for a loan secured by a dwelling, regardless of whether the documents constitute a Title XI appraisal or evaluation, or, as a matter of course provide the borrower with the appraisal or evaluation. Thus, to the extent that a borrower benefits from knowing the value the lender places on the property the borrower has contracted to purchase or pledged as collateral, the borrower should be able to benefit from that knowledge whether it is in the form of a Title XI appraisal or an evaluation.

Furthermore, although such a disclosure is not required by RESPA, Regulation B, or Title XI, the agencies believe that a regulated institution should advise consumers whether the institution intends to have a licensed or certified appraiser

prepare the estimate of value. This should be done early enough in the loan application process to allow the consumer to make an informed decision that the intended method of estimating the real estate's value meets his or her needs.

Effects on Safety and Soundness of Financial Institutions. The agencies have concluded that a $250,000 threshold would not threaten the safety and soundness of financial institutions.

Benefits to Safety and Soundness. The agencies believe that the increase in the threshold will have affirmative benefits for safety and soundness. A decrease in appraisal requirements should relieve regulatory burden for banks and thrifts and thereby improve their competitiveness with non-regulated lenders. Appraisal costs represent a significant expense for certain small loans, making such lending less attractive to a potential borrower or less profitable for the lender. Numerous comments from lenders supported this conclusion. The problem is particularly troubling for lenders in small towns, who must pay a premium for a licensed or certified appraiser to visit the town. A GAO survey of bankers in connection with a study of small business lending revealed that the minimum cost to perform the necessary appraisal on commercial real estate property used as collateral for small business loans was approximately $3,000.[1] See GAO Report GGD-93-121, Bank Regulation: Regulatory Impediments to Small Business Lending Should Be Removed (September 1993).

Experience with the $100,000 Threshold. The Board has had a $100,000 threshold in place since August 1990, and the other

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1. The GAO noted that a survey performed by the American Bankers Association reflected a lower average cost.

agencies have had a $100,000 threshold since March or April 1992. The experience of the agencies has demonstrated that the $100,000 threshold has posed no risk to safety and soundness.

A survey by each of the agencies of its senior examination staff indicates that over a period of many years, with a few possible exceptions,[2] no bank or thrift has failed or suffered significant losses as a result of appraisal problems with loans under $100,000 or even up to $250,000. Each of the regional representatives of the Board, the FDIC, and the OCC supported adoption of the $250,000 threshold as consistent with safety and soundness. Representatives of the OTS suggested that the threshold should only apply to healthier thrifts. As described below, this concern has been addressed by the agencies in the final regulation.

The $250,000 threshold was also supported by the Conference of State Bank Supervisors (CSBS), the professional association for state officials who supervise and regulate state-chartered commercial and savings banks. The CSBS concluded that the increased threshold would reduce unnecessary costs and

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2. The Central Region of the OTS was the only OTS respondent to identify failures attributable to inadequate appraisal practices. The Central Region identified fewer than six failures over the previous twelve years where appraisal issues for loans under $250,000 were a major contributing factor to a thrift's failure. The Central Region noted that in those failures where inadequate appraisal practices were a problem, other areas of loan underwriting were usually found to be equally deficient.

One OCC survey respondent reported that one institution had failed because of residential and commercial loans between $100,000 and $500,000. The respondent noted that the problems occurred before 1987, when the OCC issued guidelines that would have prevented the institution's real estate valuation problems.

would not represent a threat to the safety and soundness of financial institutions.

Numerous bank and thrift commenters also reported that their experience with the $100,000 threshold had been good. Moreover, commenters opposed to the increased threshold did not identify institutions that had failed or suffered significant losses because of the existence of the $100,000 threshold.

The agencies believe that low loss experience with a $100,000 threshold provides justification for an increase in the threshold to $250,000.

Data Indicate Similarities Between the $100,000 Threshold and $250,000 Threshold. A substantial body of evidence provides strong reasons to believe that exempting loans between $100,000 and $250,000 from the Title XI appraisal requirement will not present materially greater risk than the prior exemption for loans under $100,000.

Data from the commercial bank Consolidated Reports of Condition and Income (Call Reports) for year-end 1992 show that approximately 53 percent of the dollar volume of all real estate-secured loans of all sizes in the commercial banking industry are loans secured by 1-to-4 family residential properties. Data from the Thrift Financial Reports (TFR) for year-end 1992 show that the number is 77 percent in the thrift industry.

Data on loan size are not reported for residential loans on the Call Report or TFR. However, information from the National Association of Realtors, the Census Bureau, and the Department of Housing and Urban Development (HUD) indicate that approximately 29 percent of the dollar volume of 1-to-4 family

real estate loans to purchase new homes, and 33 percent of the dollar volume of loans to finance the purchase of existing homes, fell below the prior $100,000 threshold. Approximately 56 percent of the dollar volume for new 1-to-4 family homes and 49 percent of the dollar volume for existing homes fell between $100,000 and $250,000. In sum, 85 percent of the dollar volume of mortgages financing new homes and 82 percent of the volume of mortgages financing purchases of existing homes will fall below the $250,000 threshold.

Thus, increasing the threshold from $100,000 to $250,000 is likely to more than double the amount of lending for 1-to-4 family residential real estate loans exempt from the Title XI appraisal requirement. Inasmuch as a solid majority of total real estate lending is composed of 1-to-4 family loans, the agencies believe that 1-to-4 family loans will be the largest block of loans exempted by the increase in the threshold.

The increase in 1-to-4 family residential real estate loans exempted by the $250,000 threshold will not affect safety and soundness, as these loans are traditionally the safest in a lending institution's portfolio. In 1992, the net loan charge-off rate[3] for all commercial bank loans secured by 1-to-4 family real estate was 0.23 percent; for thrifts, the net charge-off rate for loans secured by 1-to-4 family residential real estate was 0.22 percent. Low loss rates for 1-to-4 family residential real estate loans predate enactment of Title XI; for example, in 1991, when the great majority of 1-to-4 family loans had been originated prior to implementation of Title XI in August 1990, the charge-off rate for 1-to-4 family loans was 0.20 percent for commercial banks and

3. The net loan charge-off rate is determined by taking the dollar amount of gross losses, subtracting the amount recovered, and dividing the result by the average of outstanding loans.

0.11 percent for thrifts. See FDIC Quarterly Banking Profile (4th Quarter 1991) and Thrift Financial Reports (1991).

Beginning June 30, 1993, commercial banks and thrifts are required to report annually the number and dollar amount of non-farm non-residential real estate loans, which basically constitute business loans secured by real estate. They are also required to report the number and dollar amount of all agricultural loans.

The data from the June 1993 Call Reports show that 12 percent of the dollar volume of real estate-secured business loans was below the $100,000 threshold. Also by dollar volume, only 11 percent of outstanding real estate-secured business loans fell between $100,000 and $250,000. For thrifts, the TFRs show that 10 percent of the dollar volume of all real-estate secured business loans was below $100,000, and 9 percent between $100,000 and $250,000.

These findings are consistent with data compiled in the 1989 National Survey of Small Business Finances, which surveyed firms with fewer than 500 employees. See National Survey of Small Business Finances (1989) (cosponsored by the Federal Reserve Board and Small Business Administration). According to that survey, of the commercial mortgages to small businesses by depository institutions, 6 percent of the dollar volume of these loans was in loans of less than $100,000, and 12 percent was in loans between $100,000 and $250,000.

As noted in the regional examiner surveys, the $100,000 threshold has not resulted in significant losses, even though that threshold captures 12 percent of the dollar volume of small business loans. The agencies do not believe that an increase in the threshold that exempts another 11 percent of business loans will significantly increase such losses.

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Call Report data also show that 63 percent of the dollar volume of agricultural real estate loans fell below the $100,000 threshold, and that 15 percent fell between $100,000 and $250,000. For thrifts, TFR data show that 46 percent of farm loans fell below $100,000, and 36 percent between $100,000 and $250,000. Farm loans represented approximately one-half of one percent (.58%) of non-residential mortgages held by thrifts. Thus, in the area of farm loans, only a relatively small amount of additional loans will be exempted by the raised threshold.

Although the increase in the threshold will increase the dollar volume of exempt transactions, the agencies believe that the quality of loans and lending practices of banks and thrifts will not change for these transactions. Moreover, an institution must obtain evaluations for these exempt transactions when it does not obtain appraisals.

In addition, there is evidence that the loss rates on loans below the $250,000 threshold will be low. For 1992, the commercial bank loss rate for farm loans was .23 percent (approximately the same loss rate as for 1-to-4 family loans). These loss rates on residential and farm loans are significantly lower than the loss rates for the types of real estate loans that are much less likely to fall below the $250,000 threshold—construction loans (3.54% loss rate for commercial banks) and multifamily loans (1.68% loss rate for commercial banks). Loss rates for non-farm non-residential real estate loans at commercial banks were 1.55 percent, higher than residential or farm loans, but still below the loss rates experienced for loans for construction or multifamily housing.

Finally, in addition to the relatively lower risk of the portfolio of real estate related loans between $100,000 and

$250,000, the fact remains that the dollar amount of each credit is relatively small. In the experience of the agencies, banks and thrifts generally do not fail because of real estate-related financial transactions under $250,000. It is generally large construction and development loans that have created safety and soundness problems. For example, much of the thrift losses of the 1980s were caused by losses in large, speculative real estate development projects, such as construction of offices, condominiums, and apartments. See, e.g., GAO Report AFMD 89-62, Thrift Failures: Costly Failures Resulted from Regulatory Violations and Unsafe Practices. Such projects generally involve loans in much greater amounts than $250,000. The experience of the agencies continues to be that larger development and construction loans are most likely to cause significant losses.

Although many commenters suggested that raising the threshold would result in losses similar to those of the thrift failures of the 1980s, they did not offer analysis to support those statements. The agencies do not believe that inadequate appraisals on loans under $250,000 were a significant cause of those failures.

Additional Protections. Significant protections exist so that loans under $250,000 will not create a safety and soundness problem once the $250,000 threshold is in place.

First, each agency will, during each required full-scope, on-site examination, analyze the prudence of each institution's credit underwriting practices, including appraisal and evaluation practices, as appropriate to the institution's size and nature of its real estate-related activities. If an institution is doing a poor job of evaluating real estate for transactions under $250,000, then the appropriate agency may order the institution to obtain appraisals

for certain loans or for all loans above a certain amount that are not subject to another exemption.[4]

Second, even though a bank or thrift will not generally be required to obtain a Title XI appraisal for real estate-secured loans under $250,000, the institution must determine the value of the real estate before making the loan. Under the appraisal regulations, banks and thrifts must support any transaction below the threshold with an evaluation that is consistent with the agencies' guidelines. Evaluations will be performed by persons who are capable of rendering an appropriate estimate of value of real estate as a result of their real estate-related experience or training.

As several commenters noted, a $250,000 threshold will have its greatest effect in smaller communities where property values are lower. However, as many community bank commenters pointed out, local lenders in small communities tend to be extremely knowledgeable of property values. Also, collateral for loans of this size do not typically represent complex problems of analysis or valuation.

Third, a $250,000 threshold does not prevent the use of appraisals when needed. Banks and thrifts may obtain appraisals prepared by licensed or certified appraisers whenever the institutions believe it is prudent, and customer may independently obtain such appraisal. If, as some commenters contend, history demonstrates that such appraisals are important to the decision to lend and the failure to obtain such an appraisal

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4. As noted below, the agencies may require an appraisal for loans between $100,000 and $250,000 (not otherwise subject to an exemption) when an institution is in troubled condition, and that troubled condition is attributable to underwriting problems in the institution's real estate loan portfolio.

will lead to higher loss rates, then banks and thrifts would presumably have a strong incentive to use appraisals. As several commenters noted, institutions will obtain appraisals when their underwriting criteria warrant one, regardless of whether regulations require it.

Fourth, in many cases involving residential real estate, banks and thrifts will be required to obtain the equivalent of a Title XI appraisal in order to make the loan eligible for sale in the secondary market. According to HUD data, in 1992, secondary mortgage market purchasers, such as the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), purchased approximately 63 percent of all l-to-4 family mortgages originated in the United States. In addition to the 63 percent that were purchased by major secondary mortgage market entities, other loans were originated so as to be eligible for sale to such entities. The agencies have concluded that the appraisal requirements of these government sponsored agencies should protect federal financial and public policy interests in the loans that are eligible to be purchased by them. The agencies also believe that compliance with these appraisal requirements will protect the safety and soundness of regulated financial institutions.

Data Submitted by Commenters. The notice of proposed rulemaking asked commenters to submit loan loss data for different categories of real estate-secured loans above and below $250,000. Many depository institution commenters noted that they do not maintain loss data by loan size and that this information is not reasonably accessible. Only a small number of depository institutions submitted such data. The agencies do not believe that this response is sufficiently large to base any conclusions about industry-wide conditions. Nonetheless, the agencies note that the information provided by commenters is

consistent with the low loss rates for real estate lending indicated by other sources. The responses that the agencies received are summarized in the following table.

Real estate-secured loans	Size of loans	Number of loans	Outstanding principal amount of loans[1] (12/31/92)	Loss on loans[1] (annual net charge-offs)[2] (12/31/92)	Loss rate[3] (calculated) (percent)
Loans secured by 1-to-4 family residential real estate.	Loans greater than $250,000	7,151	3,169,918	4,129	0.13
	Loans of $250,000 or less.....	524,137	22,240,821	22,773	.11
Loans secured by commercial real estate.	Loans greater than $250,000	25,344	28,315,961	372,706	1.32
	Loans of $250,000 or less.....	67,469	5.131,866	36,751	0.72

1. Dollars rounded to thousands.

2. Annual net charge-offs are determined by taking the dollar amount of gross losses and subtracting the amount recovered.

3. The agencies have calculated the loss rate for each of the categories of real estate-secured loans about which the agencies requested data by dividing total annual net charge-offs by the total outstanding principal balance.

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Additional Comments on the $250,000 Threshold — MB Study. Several commenters opposing an increase in the threshold pointed to an August 1992 study by the Office of Management and Budget (OMB) entitled Report to Congress: De Minimis Levels for Commercial Real Estate Appraisals. The OMB study did not oppose an increase in the threshold level but instead stated, "OMB does not recommend — at this time — a *de minimis* level higher than $100,000. . . ." OMB study at i.

The agencies believe that the major concerns identified by the OMB in urging delay have been addressed with the passage of time. Most importantly, each of the agencies now has an additional year's experience with the $100,000 threshold. Furthermore, OMB noted that FIRREA's appraisal requirements had not been implemented in all states, but such implementation has now occurred.

Rulemaking Process. Several commenters stated that the agencies had failed to justify increasing the threshold from $100,000 to $250,000 because the agencies had not produced a definitive study showing that doing so would not increase loss rates.

Congress granted the agencies explicit authority to establish a threshold consistent with safety and soundness. The delegation of authority was broad, and no requirement for quantitative analysis was included. Nor is it reasonably feasible for the agencies to conduct a definitive quantitative analysis that isolates the effect of obtaining Title XI appraisals on institutions' losses on real estate-secured loans given the many variables, including changing market conditions and varying loan underwriting practices, that may affect institutions' ultimate loss experience. For the same reason, the agencies did not conduct a random

sampling of the experience of financial institutions, as suggested by one commenter. This does not mean, however, that the final rule fails to rely on objective data. Moreover, that data was analyzed in light of the agencies' experience and expertise.

As part of this rulemaking, the agencies reviewed the data the agencies currently collect from financial institutions and sought out data that would enable the agencies to analyze the effect of the threshold on regulated institutions. Consistent with statutory requirements, the agencies have carefully considered the effect of raising the threshold and determined that a $250,000 threshold level does not represent a threat to the safety and soundness of financial institutions based on the agencies' judgment, expertise, and experience. In making this determination, the agencies have, as described above, analyzed the available data, the comments received during the rulemaking, and relevant work of other governmental agencies.

Appraiser Employment. Many commenters from the appraisal industry objected to the proposed increase in the threshold on the grounds that it would decrease their business and employment in the appraisal industry.

In the event that an appraisal is not required because the transaction falls below $250,000, the appraisal regulation nonetheless requires that an evaluation of the property be conducted. The agencies' appraisal rules do not impede licensed and certified appraisers from performing these evaluations.

GAO Study. Several commenters suggested that the agencies delay action on any rulemaking pending completion of General Accounting Office (GAO) studies of the threshold scheduled for completion in April 1994 and October 1995.

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Congress delegated authority to the agencies to establish a threshold in the same legislation that directed the GAO to conduct two studies of the appraisal threshold. Congress clearly did not require the agencies to withhold action on the threshold pending completion of the GAO studies; nor did it make agency action contingent on the outcome of the GAO studies or any other studies. Also, in the Interagency Policy Statement on Credit Availability issued March 10, 1993, the agencies identified a need to reexamine their existing appraisal rules to make certain that thresholds below which formal appraisals are not needed are reasonable. Therefore, the agencies believe that it is appropriate to proceed with the rulemaking. The agencies are cooperating with the GAO by providing information that it may use in preparing its studies.

Private Mortgage Insurance Industry Experience. A trade association representing the private mortgage insurance industry opposed increasing the threshold level to $250,000, citing substantial losses on loans under $100,000. However, it also noted that for loans originated in 1984, loans above $250,000 had a relative claim rate more than 50 percent higher than the claim rate for loans originated under $100,000. Information provided by this commenter also showed that the relative claim rates on loans below $100,000 and loans between $100,000 and $250,000 were close for most years, while the relative claim rate for loans above $250,000 exceeded the claim rates for loans below $250,000 in all years except one. The commenter did not provide actual claim rates nor dollar amounts of claims. Nor did the commenter disclose the average loan-to-value ratios for those mortgages, a factor that could affect the loss experience.

Although the trade association stated its belief that a significant amount of the claims experienced by its members were related to inadequate appraisals, bank and thrift

commenters stated that losses on foreclosed properties were more directly related to deterioration in the local real estate market, damage to the property, or actions or inaction by the borrower.

Application of $100,000 Threshold to Certain Troubled Institutions. As described in more detail below, the agencies are adopting substantially as proposed a separate amendment stating that each agency continues to reserve the right to require a regulated institution to obtain a Title XI appraisal whenever the agency believes that an appraisal is necessary to address safety and soundness concerns. This authority may involve the agency requiring an institution to obtain an appraisal for a particular extension of credit or an entire group of credits.

Whether an institution will be required, pursuant to this provision or existing safety and soundness authority, to obtain an individual appraisal or group of appraisals may depend on the condition of that institution. If an institution's troubled condition is attributable to real estate loan underwriting problems, then the appropriate agency may require appraisals for all new real estate-related transactions of more than $100,000 that are not subject to an exemption.

Since thrift industry assets are concentrated in real estate loans, OTS believes that problem thrifts or thrifts in troubled condition[5] generally will have real estate-related asset quality

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5. A "problem" association is defined as an association that: (1) Has a composite MACRO rating of 4 or 5; (2) is undercapitalized under prompt corrective active standards; (3) is subject to a capital directive or a cease and desist order, a consent order, or a formal written agreement, relating to the safety and soundness or financial viability of the savings association, unless otherwise informed in writing by the OTS; or (4) has been notified in writing by the OTS that is has been designated a problem association or an association in troubled condition. (See Regulatory Bulletin 27a, Executive Compensation.)

problems. As a matter of policy, OTS intends to require thrifts in troubled condition to adhere to a $100,000 threshold.

Reassessment of Threshold. Finally, just as the agencies have reviewed their experience with the $100,000 threshold in determining whether a higher (or lower) threshold was appropriate, so too will the agencies review their experience with the $250,000 threshold. If the agencies should determine that the increased threshold is causing safety and soundness problems, then the agencies will reassess that threshold.

(2) The "Abundance of Caution" Exemption

The agencies are amending their regulations to clarify and expand the scope of the exemption for real estate liens taken in an "abundance of caution." Under the amended rule regulated institutions will be able to apply the abundance of caution exemption to a broader range of transactions in which real estate is taken as additional collateral for an extension of credit that is well supported by income or other collateral of the borrower.

Prior to adoption of this amendment, the abundance of caution exemption was available only for transactions in which a lien on real estate had been taken as collateral solely through an abundance of caution and where the terms of the transaction as a consequence had not been made more favorable than they would have been in the absence of a lien. In the agencies' experience, however, this standard was being interpreted too narrowly. As a result regulated institutions obtained appraisals even though they were unnecessary to protect federal financial and public policy interests in the transaction or bank and thrift safety and soundness. Further, a transaction would not qualify for the exemption if the regulated institution made the terms more

favorable to the borrower because of the real estate collateral. Therefore, bankers believed they were unable to use this exemption when common business practices would call for a lower interest rate on a secured loan than an unsecured loan.

To qualify for the amended exemption, the regulated institution's decision to enter into the transaction must be well supported by the borrower's income or collateral other than real estate. The following examples from the proposed rule help to explain how this standard is applied.

Example 1A business with an established cash flow seeks a loan from a regulated institution to purchase an adjacent property for expansion. As a common business practice, the institution takes a lien against real estate whenever available for greater comfort. However, the institution's analysis determines that the current income from the business and personal property available as collateral support the decision to extend credit without knowing the real estate's market value. During loan negotiations, the institution offers to make the loan on slightly better terms for the borrower if it receives a lien on real estate. The borrower accepts the offer and provides the real estate as additional collateral.

The regulated institution may reasonably conclude that the lien on the real estate was taken in an abundance of caution because the current income from the business and personal property taken as collateral support the decision to extend credit. Therefore, no appraisal would be required.

Example 2: The owner of a shop seeks a term loan from a regulated institution for modernization of its facilities. The institution determines that other sources of repayment and

collateral do not sufficiently support the decision to extend credit without taking a lien on the real estate and knowing the real estate's market value. Therefore, in order to extend credit to the borrower prudently, the institution needs an appraisal.

The regulated institution should conclude that the real estate lien has *not* been taken in an abundance of caution because the other sources of repayment and collateral do not support the decision to extend credit without knowing the real estate's market value. This transaction would not qualify for the abundance of caution exemption.

Regulated institutions generally supported the proposed amendment. Some commenters representing appraisers agreed that the abundance of caution exemption had been too narrowly interpreted and supported the proposal to extend the scope of the exemption.

Other appraisers commented that the agencies should require an appraisal, limited scope appraisal, or evaluation any time a regulated institution takes real estate as collateral. Some regulated institutions noted that the prior rule caused them to forgo liens on real estate collateral in order to avoid the expense of an appraisal, thus potentially increasing their exposure unnecessarily.

The agencies are not requiring appraisals for these transactions because an estimate of the real estate collateral's value generally would not assist the regulated institution to make its lending decision. Therefore, an appraisal generally would not further the purposes of Title XI of FIRREA nor significantly improve the safety and soundness of financial institutions.

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(3) Loans Not Secured by Real Estate

The agencies are adopting a uniform exemption for transactions that are not secured by real estate. The exemption makes clear that a regulated institution is not required to obtain a Title XI real estate appraisal in connection with a loan used to acquire or invest in real estate if the institution does not take a security interest in real estate.

The prior appraisal regulations of the OCC, FDIC and OTS exempted these transactions, and the amendment does not result in any substantive change in regulatory requirements for these agencies. The amendment eliminates minor differences between the text of the rules adopted by the OCC and OTS and the text of the FDIC's rule. Prior to adoption of the amendment, the Board's appraisal regulation did not specifically exempt these transactions.

Although a few appraisers stated that Title XI appraisals should be obtained for these transactions, other commenters, including appraisers, supported this exemption. Several commenters stated that Title XI was never intended to reach transactions that were not secured by real estate.

In transactions covered by this exemption, the value of the real estate has no direct effect on the regulated institution's decision to extend credit because the institution has no security interest in the real estate. The agencies conclude that federal financial and public policy interests would not be served by requiring lenders and borrowers to incur the cost of obtaining Title XI appraisals in connection with these transactions.

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(4) Liens for Purposes Other Than the Real Estate's Value

The agencies are adopting a new exemption for transactions in which a regulated institution takes a lien on real estate for a purpose other than the value of the real estate. This amendment will permit regulated institutions to take liens against real estate to protect rights to, or control over, collateral other than the real estate without obtaining an appraisal.

Regulated institutions frequently take real estate liens to protect legal rights to other collateral and not because of the value of the real estate as an individual asset. For example, in lending associated with logging operations, a regulated institution typically takes a lien against the real estate upon which the timber stands to ensure its access to the timber in the event of default. Similarly, where the collateral for a loan is a business or manufacturing facility, a regulated institution may take a lien against the land and improvements in order to be able to sell the entire business or facility as a going concern if the borrower defaults.

A Title XI appraisal contains an opinion of the market value of real estate. When the market value of the real estate as an individual asset is not needed to support the regulated institution's decision to lend, no purpose is served by requiring the institution to obtain a Title XI appraisal.

Commenters generally favored adopting an exemption addressing these circumstances, agreeing that Title XI appraisals did not enhance the safety and soundness of these transactions because the lenders were basing their decision to extend credit on the value of collateral other than real estate.

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Some commenters suggested that this exemption could be combined with the abundance of caution exemption. Although there are situations in which the two exemptions overlap, the agencies believe that both exemptions are necessary because there will be transactions that qualify for one exemption, but not the other.

(5) Real Estate-Secured Business Loans of $1 Million or Less

The agencies are adopting a new exemption for business loans with a value of $1 million or less where the sale of, or rental income derived from, real estate is not the primary source of repayment. The agencies also are adopting the proposed definition of "business loan" as a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship (including an individual engaged in farming), or other business entity. This provision allows a regulated institution to take real estate as security in connection with a loan to a small- or medium-sized business when the primary source of repayment for the loan does not depend on sale of, or rental income derived from, real estate.

The final rule differs in two respects from the proposed rule. First, the exemption is available for business loans of $1 million or less. The proposed rule would have exempted business loans less than $1 million. The change was adopted to reduce confusion by making this provision consistent with the way other limits are treated in the rule. The change affects the scope of the exemption very slightly.

Second, under the final rule, the exemption is available for business loans that do not depend on real estate sales and rental income as the primary source of repayment for the loan. The

proposed rule would have exempted business loans that were not dependent on sale of, or rental income derived from, the real estate taken as collateral as the primary source of repayment. The change narrows the scope of the exemption by preventing a borrower from qualifying for the exemption by showing that the primary source of repayment for the loan is income from real estate sales and rentals involving real estate other than the real estate in which the lender has a security interest. This means, for example, that a real estate developer cannot qualify for the exemption by showing that a real estate-secured loan for one project, in which the lender has taken a security interest, will be repaid with income from real estate sales or rentals from other real estate projects, in which the lender does not have a security interest.

The following examples illustrate the application of this exemption.

Example 1: The owner of a shop seeks a term loan for $1 million or less from a regulated institution. The loan will be repaid with income derived from operations. The regulated institution would not extend credit to the borrower without a lien against the real estate.

However, because the loan is for $1 million or less and the sale of, or rental income derived from, real estate is not the primary source of repayment, a Title XI appraisal would not be required for this transaction under this exemption.

Example 2: A company acquires an adjacent parcel of land to construct an office building. The company seeks a loan of $1 million or less from a regulated institution to provide construction financing and a permanent mortgage for the office

building. The company intends to lease part of the building and will use the rental income to help repay the loan. The lender estimates that operations of the business would contribute approximately 45 percent of the funds necessary to repay the loan and rental income approximately 55 percent.

The regulated institution should conclude that rental income derived from real estate serves as the primary source of repayment for the loan. Therefore, assuming no other exemption is applicable to the transaction, a Title XI appraisal would be required.

Increased Lending to Small- and Medium-Sized Businesses. In the experience of the agencies, the appraisal requirement may have adversely affected the ability of small- and medium-sized businesses to obtain credit. In particular, there are indications that the cost of an appraisal may impede small- and medium-sized businesses from receiving working capital, operating loans, and other business-related credits that otherwise would be consistent with prudent banking practice.

The majority of financial institutions and financial institution trade associations that responded to the agencies' request for comment on the effect of the business loan exemption on credit availability stated that the proposed exemption would increase credit availability by reducing the cost and time to make real estate-secured business loans. These commenters generally stated that the changes would have the most significant effect on credit availability for small- and medium-sized businesses. Some appraisers also stated that the proposed changes would increase credit availability.

A large number of commenters responding to the specific

request for comment thought that the changes would have no effect on credit availability. These commenters included appraisers and appraiser trade associations, a small number of financial institutions, and other commenters. Some of these commenters stated that the ability of financial institutions to earn a reasonable return by making relatively risk-free investments in U.S. government securities was the cause of credit availability problems.

The agencies believe that the final rule may reduce the cost of real estate-secured loans to small- and medium-sized businesses and increase the availability of loans to these borrowers.

Effect on Safety and Soundness. Some commenters stated that this exemption would eliminate the requirement to obtain Title XI appraisals for a large portion of the real estate-secured business loans in their communities. Others stated that this exemption raised safety and soundness concerns because the only tangible collateral for many businesses is real estate. Though real estate may be an important asset of many small- and medium-sized businesses, the agencies have concluded that this exemption for certain business loans that do not rely on real estate as the primary source of repayment will not threaten the safety and soundness of regulated institutions nor pose a threat to federal financial and public policy interests.

Although the agencies are not requiring Title XI appraisals in connection with these business loans, the agencies are requiring regulated institutions to obtain appropriate evaluations of the real estate collateral. The evaluation should provide the institution with sufficient information on the value of the real estate to satisfy principles of safe and sound banking. In addition,

during each required full-scope, on-site examination, each agency will analyze the prudence of each institution's credit underwriting practices, including appraisal and evaluation practices, as appropriate to the institution's size and nature of its real estate-related activities.

Shortly after the agencies issued the proposed rule, the GAO completed its report entitled *Regulatory-Impediments to Small Business Lending Should Be Removed* (September 1993). In the report's summary, the GAO stated: "Specifically, we believe that real estate appraisal requirements can be safely modified when applied to collateral taken as supplementary support for traditional small business loans. Therefore, we agree with those aspects of the rule changes recently proposed by the banking regulators to expand the exemptions from mandatory appraisals as they pertain to such loans." The GAO noted that the report and its comment on the proposed appraisal regulations were limited "to situations in which real estate collateral is used to support loans to small businesses for such purposes as working capital and equipment purchases." This exemption is intended to reach these loans, as well as loans for other business purposes where sale of, or rental income derived from, real estate is not the primary source of repayment.

The conclusion that exempting these transactions will not threaten the safety and soundness of financial institutions is supported by responses to a 1993 OCC survey of its senior examining staff. The survey asked for information on the effect of the proposed business loan exemption on bank safety and soundness, as well as information on the significance, by loan size, of losses on loans secured by 1-to-4 family residential real estate and other categories of real estate.

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Eighteen of the 20 respondents to the OCC survey stated that the proposed exemption for business loans would not threaten the safety and soundness of financial institutions, although some respondents noted that the exemption could present more serious risks for small financial institutions. Respondents to the survey identified loans above $1 million secured by nonresidential real estate as the category of transactions that had the most significant losses attributable to inadequate appraisals, followed by loans secured by non-residential real estate in the ranges $750,000 to $1 million and $500,000 to $750,000.

In general, respondents noted that where real estate serves as only a secondary source of repayment for a business loan, an evaluation of the collateral would be sufficient to address safety and soundness issues. Although the other bank regulatory agencies' surveys did not include the specific questions posed in the OCC survey, the results of the other bank regulatory agencies' surveys also generally support the business loan exemption.

In addition to the survey responses, the data from the 1992 commercial bank Call Reports and savings associations' TFR indicate that the exposure to the banking system from these transactions is limited. All commercial loans secured by non-farm non-residential real estate in the range between $250,000 and $1 million (this includes both non-exempt and exempt transactions) represent less than 4 percent of all loans for commercial banks and less than 3 percent of all loans for savings associations. Furthermore, these loans represent less than 27 percent of commercial loans secured by non-farm non-residential real estate at commercial banks and less than 36 percent of commercial loans secured by such real estate at savings associations. This generally agrees with the National Survey of Small Business Finances (1989), cosponsored by the Federal

Reserve Board and Small Business Administration. The results of the survey (adjusted to 1992 dollars) show that 22 percent of all commercial mortgages were for amounts between $250,000 and $1 million.

The agencies requested specific comment on loss experience for real estate-secured business loans. Only a small number of banks and no thrifts submitted the requested data. Although the agencies do not believe the response is large enough to reach conclusions about industry-wide loss experience, the data submitted is consistent with the conclusion that regulated institutions are not suffering high levels of losses in connection with real estate-secured business loans of $1 million or less that do not depend on real estate sales or rental income as the primary source of repayment. The responses that the agencies received are summarized in the following table.

Real estate-secured loans[1]	Number of loans (12/31/92)	Outstanding principal amount of loans[2] (12/31/92)	Loss on loans[2] (annual net chargeoffs)[3] (12/31/92)	Loss rate[4] (calcu-lated) (percent)
All real estate-secured business loans	90,410	17,488,561	178,237	1.02
Real estate-secured business loans less than $1 million that are not dependent on the sale of, or rental income derived from, the real estate taken as collateral as the primary source of repayment for the loan	59,595	8,008,422	32,680	0.41

1. None of the comment letters received by OTS included data on these loans.

2. Dollars rounded to thousands.

3. Annual net-charges are determined by taking the dollar amount of gross losses and subtracting the amount recovered.

4. The agencies have calculated the loss rate for both categories of real estate-secured loans about which the agencies required data by dividing total annual net charge-offs by the total outstanding principal balance.

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Limited to Business Loans of $1 Million or Less. The exemption applies only to transactions involving business loans with a value of $1 million or less. Capping the exemption at $1 million serves two purposes. It helps to ensure that the transactions involve small- and medium-sized businesses. It also limits the overall exposure of the banking system to transactions exempt under this provision.

Some commenters stated that a $1 million limit may be too high for small institutions and suggested that the limit be set at a percentage of the institution's capital. Others stated that the exemption should cover business loans of any size.

Regulated institutions typically are subject to capital-based lending limits that restrict the amount of credit they can extend to any one borrower. While a $1 million business loan may be much more significant to a smaller institution the agencies believe that a second capital-based limit in the appraisal regulation is inappropriate because it can place smaller institutions at a competitive disadvantage to larger institutions. In addition, the agencies regularly examine the lending practices of all regulated institutions and can address problems with individual institutions if they arise. The agencies believe it is appropriate, however, to place a limit on the size of loan that can qualify for this exemption. Many commenters agreed that a $1 million dollar limit was appropriate.

Primary Source of Repayment. Some commenters suggested that the exemption should be available only if the borrower could repay the loan entirely from sources other than sale of, or rental income derived from, real estate. Commenters also suggested specific percentage limits on the contribution of real estate to repayment of the loan ranging from 10 to 50 percent. Other

commenters stated that the exemption should allow a regulated institution to determine whether a business loan requires an appraisal regardless of the contribution of real estate sales or rental income to the borrower's repayment of the loan.

The exemption is intended to improve the ability of small- and medium-sized businesses to obtain real estate-secured loans for business purposes. As the contribution of real estate sales and rentals to the borrower's sources for repaying the loan increases, repayment becomes more dependent on the performance of the real estate market. Therefore, in deciding whether a transaction qualifies for this exemption, regulated institutions should be guided by the importance of the real estate-related sources of income to the borrower's repayment of the loan, rather than applying a universal numerical cap. In no case, however, may a business loan qualify for this exemption if real estate-related sources of income contribute more toward repayment of the loan than non-real estate sources of income.

Exempting these business loans will reduce the adverse effects on small- and medium-sized business lending associated with the requirement to obtain a Title XI appraisal. Moreover, since repayment of these loans generally will not depend primarily on the performance of the real estate markets, allowing lenders to make these business loans on the basis of evaluations of the real estate collateral does not threaten the safety and soundness of financial institutions.

Agricultural Lending. The agencies received comment letters from appraisers in rural areas who stated that the exemption should not apply to agricultural production loans because use of the real estate generates the income for repayment of the loan. For, any transaction exempt under this provision, the

regulated institution is responsible for documenting that the borrower's sources of income are not primarily dependent upon the sale of, or rental income derived from, real estate. The agencies do not view the sale of growing crops as the sale of real estate, nor as providing rental income derived from real estate. The agencies have concluded that transactions involving agricultural operations present no greater risk than other types of business operations, provided the primary source of repayment for the loan is not sale of, or rental income derived from, real estate.

(6) Leases

The agencies did not propose changes to the existing exemption for leases. Under this exemption, regulated institutions are not required to obtain appraisals of leases that are not the economic equivalent of the purchase or sale of real estate.

Even though the agencies did not propose changes to this exemption, some commenters suggested that Title XI appraisals should be required if a regulated institution takes any security interest in a real estate lease. The distinction between operating leases and capital leases is well recognized in accounting practice. Consistent with the distinction in accounting for operating and capital leases, the agencies have concluded that, in general, operating leases, which are not equivalent to the purchase or sale of the leased property, should not require Title XI appraisals given the limited real estate interest such leases represent.

In transactions that involve capital leases (leases that are the economic equivalent of purchasing or selling real estate), the given real estate interest is of sufficient magnitude to be counted

as an asset of the lessee under accounting practices. Generally, the agencies will continue to require regulated institutions to obtain appraisals in connection with transactions that involve capital leases.

(7) Renewals, Refinancings, and Other Subsequent Transactions

The agencies are adopting a modified version of the proposed exemption for renewals, refinancings, and other subsequent transactions at the lending institution to simplify the conditions under which the exemption applies. Under the final rule, regulated institutions will be permitted to renew or refinance existing extensions of credit without first obtaining a Title XI appraisal for two general classes of transactions.

First, a subsequent transaction is exempt provided there has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new funds. This modification to the proposed rule is intended to emphasize that an institution must consider the effect of changes in market conditions and physical aspects of the property on its collateral protection when it advances funds in excess of reasonable closing costs as part of a renewal, refinancing, or other subsequent transaction.

Second, a subsequent transaction is exempt provided that no new monies are advanced other than funds necessary to cover reasonable closing costs. The proposed rule did not explicitly address this class of transactions.

The agencies note that this exemption would not be applicable if a borrower refinances a mortgage with a new lender.

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Prior to the adoption of this amendment, the agencies did not require a Title XI appraisal for a subsequent transaction that resulted from a maturing extension of credit if:

(i) The borrower had performed satisfactorily according to the original terms;

(ii) No new monies were advanced other than as previously agreed;

(iii) The credit standing of the borrower had not deteriorated; and

(iv) There had been no obvious and material deterioration in market conditions or physical aspects of the property which would threaten the institution's collateral protection.

In the agencies' experience, the original exemption may not have provided sufficient flexibility to regulated institutions and borrowers when a transaction was refinanced before its maturity. This is particularly true for refinancings to reduce a loan's interest rate. Further, bankers questioned whether a Title XI appraisal would be required for a refinancing where the borrower's payment history is sound and future repayment prospects are good, but the borrower's collateral has declined in value as a result of a general market decline. The agencies believe that not requiring a Title XI appraisal in such refinancings is consistent with safe and sound banking practices because the amount of the loan (except for the addition of reasonable closing costs) and the lender's collateral remain the same, and the lower loan payments may improve the ability of the borrower to repay the loan without adversely affecting the likelihood that the lender will be repaid.

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If a subsequent transaction that includes the advancement of additional funds does not result in the level of collateral protection being threatened, despite a change in the market conditions or physical aspects of the property, a Title XI appraisal need not be obtained. For example, a loan originally extended with a low loan-to-value ratio could be renewed and additional funds advanced above closing costs without a Title XI appraisal, even though market conditions have deteriorated, if the regulated institution after verifying the value of the collateral, concludes that the new loan-to-value ratio will provide adequate protection.

Similarly, if a borrower is refinancing a loan where the real estate collateral is located in a market that has experienced significant appreciation, the institution should ensure that the advancement of any new monies is based on substantiated appreciation in value. An institution can advance funds against an appreciated property whose future use is consistent with the use described in the original appraisal. If an institution makes a substantial advance that could possibly threaten the institution's collateral protection, it should consider the need to obtain a new Title XI appraisal. This exemption would not be available if a material change in the use of the property produces the reported appreciation, such as when property is rezoned for a different use.

While a Title XI appraisal is not required for transactions that qualify for this exemption, regulated institutions are required to obtain an appropriate evaluation of the collateral in accordance with the agencies' guidelines. The level of analysis and information included in the evaluation should be more detailed as the institution's exposure in the transaction increases.

Several commenters raised questions about the applicability of this exemption to loan restructurings and workouts. In such

situations, the commenters contended that requiring a Title XI appraisal may impede an institution's ability to obtain additional real estate collateral to shore-up its position or to advance new funds to protect its existing collateral position. The agencies acknowledge that the time and cost of obtaining a Title XI appraisal may present barriers to institutions in their negotiations with borrowers in a loan restructuring or workout. The agencies believe that this situation has been addressed in the regulation and the agencies' guidance, such as the November 7, 1991 Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans. It is the agencies' policy to encourage lenders to work constructively with their borrowers when restructuring existing loans that have credible support for repayment.

(8) Transactions Involving Real Estate Notes

The agencies are adopting a modified version of the proposed exemption for transactions involving real estate-secured loans, loan participations, pooled loans, interests in real property, and mortgage-backed securities. The amendment clarifies when regulated institutions may engage in secondary mortgage market transactions involving real estate loans and other interests in real estate without obtaining a new Title XI appraisal.

The exemption adopted by the agencies clarifies and allows regulated institutions to purchase, sell, invest in, exchange, or extend credit secured by, real estate-secured notes or interests in real estate without obtaining a new Title XI appraisal if each note or real estate interest is supported by an appraisal that met the regulatory appraisal requirements for the institution at the time the real estate-secured note was originated. The prior exemption

referred to purchases of these interests only. In addition, the agencies have changed the text of the final rule to more clearly state the appraisal requirements that the underlying notes must meet.

The exemption serves federal public policy interests by helping to ensure that the appraisal regulation does not unnecessarily inhibit secondary mortgage market transactions that involve these real estate-secured loans and real estate interests. The exemption makes clear that a regulated institution need not obtain new Title XI appraisals for loans originated before the effective date of the agencies' regulations in order to buy or sell them in the secondary mortgage market.

The agencies have concluded that the transaction exempted by this provision do not require new Title XI appraisals to protect federal financial and public policy interests or the safety and soundness of financial institutions. Principles of safe and sound banking practice require regulated institutions to determine the suitability of purchasing or investing in existing real estate-secured loans and real estate interests. Typically, these transactions will have a history of performance or will have been originated according to secondary mortgage market standards. The additional information from these sources, when coupled with the original documentation, permits regulated institutions to make appropriate decisions regarding these transactions.

Some commenters stated that this exemption raised safety and soundness concerns because exempt transactions may have appraisals performed before Title XI appraisal requirements went into effect. Because regulated institutions will have other sources of information about the performance of these seasoned loans, the agencies believe that new Title XI appraisals are not

necessary to ensure the safety and soundness of these exempt transactions.

Some commenters urged the agencies to expand the proposed exemption, or adopt new exemptions, to eliminate the Title XI appraisal requirement for all mortgage-backed securities. In addition, commenters suggested that the agencies exempt residential mortgage warehousing loans (loans to residential mortgage lenders who ultimately sell the mortgages to the secondary mortgage market), transactions with credit ratings by established rating agencies, or transactions that were not subject to the agencies' jurisdiction at origination.

The agencies believe that to protect federal financial and public policy interests, the underlying loans or real estate interests should have appraisals that meet the requirements that were applicable to regulated institutions when the underlying transactions were originated. For this reason, the agencies are not adopting the suggestions for exempting additional categories of transactions under this provision.

Commenters also suggested that the agencies should permit a regulated institution that purchases a pool of loans, invests in mortgage-backed securities, or secures a mortgage warehousing loan with real estate notes, to confirm that the loans have appropriate appraisals without reviewing the appraisal for each underlying loan. The agencies agree that it should not be necessary to review the appraisal for each underlying loan in all cases. The agencies believe that regulated institutions may use sampling and audit procedures to determine whether appraisals for the underlying loans in a loan pool satisfy the regulation's requirements and to verify the seller's representations and warranties.

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The agencies also believe that a regulated institution may presume that the underlying loans in an investment grade, marketable, mortgage-backed security satisfy the requirements of the appraisal regulation whenever an issuer makes a public statement, such as in a prospectus, that the appraisals comply with the agencies' regulations. To be considered investment grade, a security must be rated in one of the top four rating classifications of at least one nationally recognized statistical rating service. A marketable security is one that may be sold with reasonable promptness at a price that corresponds to its fair value.

For mortgage warehousing loans, sale to Fannie Mae or Freddie Mac of the mortgages that secure the mortgage warehouse loan may be used to demonstrate that the underlying loans complied with the appraisal requirements of the agencies' regulations. The institution, however, must continue to monitor its borrower's performance in selling loans to the secondary market and take appropriate steps, such as increased sampling and auditing of the loans and their documentation, if the borrower experiences more than a minimal rejection rate.

(9) Transactions Insured or Guaranteed by a U.S. Government Agency or U.S. Government Sponsored Agency

The agencies are adopting a uniform exemption for transactions that are wholly or partially insured or guaranteed by a United States government agency or government sponsored agency because these loans pose little risk to insured institutions. This exemption will eliminate the confusion among regulated institutions who may believe that two separate appraisals are required — one meeting the banking agencies' regulations and another meeting the federal loan programs' standards.

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The prior regulations of the OCC, FDIC, and OTS exempted many of these transactions. However, they previously required that these transactions be supported by an appraisal that conformed to the requirements of the insuring or guaranteeing agency. Prior to adoption of this amendment, the Board's appraisal regulation did not specifically exempt these transactions.

Federally insured or guaranteed transactions must meet all the underwriting requirements of the federal insurer or guarantor, including real estate appraisal requirements, in order to receive the insurance or guarantee. The agencies believe that the standards of these loan programs are sufficient to protect the safety and soundness of regulated financial institutions. Therefore, it is unnecessary to require that these transactions also meet the overlapping requirements of the banking and thrift agencies' appraisal regulations.

Some commenters suggested that the agencies should limit the application of this exemption to federal loan programs with appraisal requirements that conform to the Uniform Standards of Professional Appraisal Practice (USPAP) and require the use of licensed or certified appraisers. In addition, commenters raised concerns that some loan programs may not have appraisal standards and asked the agencies to list those loan programs to which this exemption applies.

OMB has directed federal agencies with government guaranteed or insured loan programs to conduct real estate appraisal programs in a manner to reduce default risks to the federal government. Specifically, these federal agencies are required to ensure that all real estate credit transactions over $100,000 have an appraisal performed by a state licensed or

certified appraiser and that the appraisal be conducted under appraisal standards that are consistent with the USPAP.[6]

The agencies believe that the authority of OMB to ensure that federal agencies adopt appropriate real estate appraisal standards eliminates the need to list specific loan programs for which this exemption applies. Moreover, OMB is monitoring the implementation of those appraisal programs and has required any federal agency not having appraisal standards and practices in place to submit an implementation plan and schedule to OMB. If the agencies later determine that a particular federal loan program poses a threat to the safety and soundness of regulated institutions, the agencies have retained the authority to require appraisals in such situations.

This exemption also applies to certain other real estate-related financial transactions involving government agencies or government sponsored agencies. For example, the U.S. Postal Service typically contracts with a developer to erect and lease a special purpose building for the Postal Service's use. Applicable contract procedures normally require only cost estimates when determining who is awarded the contract. The Postal Service also enters into a lease with the developer. The lease payments, which are assigned to the lender, are sufficient to repay the loan. Because the developer is complying with applicable contract procedures, which require only cost estimates, it would be an unnecessary burden for the developer or the lender to also obtain a Title XI appraisal.

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6. OMB Circular A-129, "Policy for Federal Programs and Non-Tax Receivables," revised January 1993.

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(10) Transactions That Meet the Qualifications for Sale to a United States Government Agency or Government Sponsored Agency

The agencies are adopting a modified version of the proposed exemption for transactions that meet the qualifications for sale to any U.S. government agency or government sponsored agency. By referring to any U.S. government agency or sponsored agency, the exemption includes not only loans sold to federal agencies, but also any transaction that meets the qualifications for sale to agencies established or chartered by the federal government to serve public purposes specified by the U.S. Congress. These government sponsored agencies are:

- Banks for Cooperatives.
- Federal Agricultural Mortgage Corporation (Farmer Mac).
- Federal Farm Credit Banks.
- Federal Home Loan Banks (FHLBs).
- Federal Home Loan Mortgage Corporation (Freddie Mac).
- Federal National Mortgage Association (Fannie Mae).
- Student Loan Marketing Association (Sallie Mae).
- Tennessee Valley Authority (TVA).

This exemption permits regulated institutions to originate,

hold, buy, or sell transactions that meet the qualifications for sale to any U.S. government agency and the above listed government sponsored agencies without obtaining a separate appraisal conforming to the agencies' regulations.

The exemption contains a modification to the original proposal that permits regulated institutions to accept appraisals performed in accordance with the appraisal standards of Fannie Mae and Freddie Mac for any residential real estate transaction, both single family and multifamily regardless of whether the loan is eligible to be purchased by Fannie Mae or Freddie Mac. This modification clarifies that a regulated institution's "jumbo" or other residential real estate loans that do not conform to all the underwriting standards of Fannie Mae or Freddie Mac, but that are supported by an appraisal that meets the appraisal standards of these agencies, will qualify for this exemption.

This exemption expands the prior exception to the regulations of the OCC, FDIC, and OTS for transactions involving 1-to-4 family residential properties that had appraisals conforming to the appraisal standards of Fannie Mae and Freddie Mac. In addition, the OTS exception applied to existing multifamily properties. These transactions were not required to comply with the additional supervisory standards set forth in the prior regulations. The Board did not have a similar exception in its prior regulation.

Some commenters requested that the agencies continue the prior exception allowing the use of Fannie Mae or Freddie Mac standards for any loans involving 1-to-4 family residential real estate. Other commenters stated that the proposed exemption should not be adopted because the agencies would not be meeting their statutory obligation to set appraisal standards for transactions within their jurisdiction.

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The agencies believe the appraisal standards of the U.S. government agencies or sponsored agencies established to maintain a secondary market in various types of loans are appropriate for these exempt transactions. Recently, Fannie Mae and Freddie Mac revised their 1-to-4 family residential appraisal standards and report forms to incorporate the USPAP as the minimum appraisal standards. Further, the appraisal standards and forms of Fannie Mae and Freddie Mac are recognized as the appraisal industry's standard for residential real estate appraisals. The agencies have concluded that those appraisal standards should protect federal financial and public policy interests in the loans that are eligible for purchase by U.S. government agencies or sponsored agencies. The agencies also believe that compliance with these standards will protect the safety and soundness of regulated financial institutions.

The agencies believe that permitting regulated institutions to follow these standardized appraisal requirements without the necessity of obtaining a separate appraisal or an appraisal supplement for conformance with the banking agencies' regulations, will reduce regulatory burden and increase an institution's ability to buy and sell these types of loans, improving the institutions liquidity.

(11) Transactions by Regulated Institutions as Fiduciaries

The agencies are adopting a new exemption for transactions in which a regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law. The amendment clarifies that regulated institutions acting as fiduciaries are not required to obtain appraisals under the agencies' appraisal regulations if no appraisal is required under other law governing their fiduciary responsibilities in connection with those transactions.

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Prior to adoption of this amendment, it was unclear whether the agencies' appraisal regulations required appraisals for all real estate-related financial transactions in which regulated institutions participated as fiduciaries. For example, other law may not require an appraisal in connection with the sale of a parcel of real estate to a beneficiary of a trust on terms specified in the trust instrument.

While financial institutions were in general agreement with the proposed exemption, some of these commenters stated that a fiduciary should be exempt from meeting Title XI appraisal requirements regardless of whether other laws require an appraisal. Commenters opposing this exemption believe that fiduciaries should be required to obtain a Title XI appraisal for all their real estate-related transactions.

The agencies have concluded that a Title XI appraisal should not be required when regulated institutions engage in real estate-related financial transactions as fiduciaries and no other law (including state common law establishing the responsibilities of fiduciaries) requires appraisals for those transactions. Losses as a result of these transactions would not, absent some negligence by the institution, be incurred by the institution. Therefore, exempting these transactions from the Title XI appraisal requirement should not adversely affect the safety and soundness of financial institutions.

When a fiduciary transaction requires an appraisal under other law, that appraisal should conform to the requirements of the agencies' regulations.

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(12) Appraisals Not Necessary To Protect Federal Financial and Public Policy Interests or the Safety and Soundness of Financial Institutions

This provision was added to the rule to make clear that the agencies retain the authority to determine in a given case when the services of an appraiser are not required.

Only few commenters addressed this issue. One commenter expressed the concern that the agencies are granting themselves the authority to create new exemptions without the benefit of public comment.

The agencies have the authority to implement and interpret regulations under their jurisdiction. The specific exemptions of the regulation describe the major categories of transactions that would not require appraisals. As a result of their experience in implementing their regulations, however, the agencies recognized that it is impossible to identify all types of transactions for which the services of an appraiser should not be required under Title XI of FIRREA and proposed this exemption to confirm their authority to determine that individual transactions do not require the services of an appraiser. The agencies will adopt any new exemptions covering broad categories of transactions in accordance with notice and comment rulemaking procedures.

§ __.3(b) Evaluations Required

The agencies are adopting a modified version of the proposed amendment concerning evaluations.

The final rule requires regulated institutions to obtain evaluations for real estate-related financial transactions that do not require Title XI appraisals because they: (i) Are below the threshold level; (ii) qualify for the exemption for business loans of $1 million or less where income from real estate is not the

primary source of repayment; or (iii) qualify for the exemption for subsequent transactions resulting from an existing extension of credit. The agencies changed the text of this amendment to make clear that institutions must still obtain evaluations for these exempt transactions. The regulation does not require the institution to have an evaluation if the transaction qualifies for an exemption other than these three exemptions.

An evaluation provides a general estimate of the value of real estate and need not meet the detailed requirements of a Title XI appraisal. An evaluation must provide appropriate information to enable the institution to make a prudent decision regarding the transaction. Because institutions must tailor evaluations to provide appropriate information for different types of transactions the content and form of evaluations will vary for different transactions.

In their prior regulations, the OCC, Board and OTS required evaluations for all real estate-related financial transactions that do not require appraisals. The FDIC's prior regulation stated that supervisory guidelines, general banking practices or other prudent standards may require an appropriate valuation of real property collateral when a Title XI appraisal is not required. For some institutions, the effect of these provisions may have been to require evaluations in cases where they did not assist in protecting the institutions' safety and soundness. The agencies are amending their regulations to require regulated institutions to have evaluations only for those real estate-related financial transactions where an understanding of the real estate's value is generally needed to assist the institution in deciding whether to enter into the transaction.

Some commenters stated that evaluations should not be

required for any exempt transactions and that the decision to obtain an evaluation should be left to the institution. Commenters suggested that the agencies should require appraisals for any transaction that requires an evaluation and raised questions about the qualifications and independence of persons performing evaluations. Some commenters stated that only licensed or certified appraisers were qualified to perform evaluations.

The agencies believe that safety and soundness principles require institutions to obtain an understanding of, and document, the value of the real estate involved in transactions that: (i) Are below the threshold level; (ii) qualify for the exemption for business loans of $1 million or less where income from real estate is not the primary source of repayment; or (iii) involve an existing extension of credit. In these cases, while a Title XI appraisal is not required to determine the value of the real estate, the agencies have concluded that regulated institutions must have an estimate of the real estate's value as a matter of safe and sound banking practice. For this reason, the agencies have decided that institutions should not have the discretion to decide whether they will obtain evaluations for these transactions. However institutions will have discretion, within the limits of safe and sound banking practice as indicated in agency guidance, to determine the content and form of the evaluation.

While licensed or certified appraisers may be qualified to perform evaluations, the agencies do not believe these appraisers are the only persons that can render a competent estimate of the value of real estate for exempt transactions. Requiring institutions to procure the services of a licensed or certified appraiser to prepare evaluations or Title XI appraisals for exempt transactions could impose significant additional costs on lenders and borrowers without significantly increasing the safety and

soundness of the transactions. However, the agencies' regulations do not, as suggested by some commenters, prohibit regulated institutions from using licensed or certified appraisers to prepare evaluations. Nor do the regulations prevent regulated institutions from obtaining Title XI appraisals for exempt transactions.

The agencies also believe that regulated institutions can take steps to ensure that the individuals performing evaluations are capable of providing an unbiased estimate of value. Institutions would generally be expected to check that persons who prepare evaluations are subject to adequate safeguards and controls to assure the integrity of the evaluation they perform. The agencies intend that regulated institutions have some flexibility in the safeguards they erect to ensure the independence of the person performing the evaluation.

The agencies' experience with transactions exempt under their prior appraisal requirements indicates that employees of a regulated institution generally can provide an unbiased and competent evaluation of real estate collateral for exempt transactions.

If there are deficiencies in an individual institution's evaluation procedures, including its procedures for determining whether to order Title XI appraisals for exempt transactions, the agencies can take appropriate steps to have the institution correct the problem. This can include requiring the institution to obtain appraisals for exempt transactions to address safety and soundness problems.

Several commenters requested that the agencies provide additional information on what is required in evaluations and

who may perform them. The agencies intend to revise their existing guidance on real estate appraisal and evaluation programs for regulated institutions to further address these issues.

§ __.3(c) Appraisals To Address Safety and Soundness Concerns

The agencies are adopting substantially as proposed an amendment stating that each agency continues to reserve the right to require a regulated institution to obtain a Title XI appraisal whenever the agency believes that an appraisal is necessary to address safety and soundness concerns. This authority may involve the agency requiring an institution to obtain an appraisal for a particular extension of credit or an entire group of credits.

Some commenters raised the concern that the agencies' authority to require a Title XI appraisal for safety and soundness purposes should be exercised only on a prospective basis. Further, several commenters noted that the agencies' authority to determine on a case-by-case basis whether an appraisal is required may lead to inconsistencies among the agencies.

Whether an institution will be required, pursuant to this provision or existing safety and soundness authority, to obtain an appraisal for a particular extension of credit, or an entire group of credits, may depend on the condition of that institution. If an institution is in troubled condition, and that troubled condition is attributable to underwriting problems in the institution's real estate loan portfolio, then the agencies may require such an institution to obtain an appraisal for all new real estate-related financial transactions below the threshold that are not subject to another exemption. Thus, for example, a troubled institution whose problems are attributable to trading losses, investment

losses, or a defalcation might be allowed to continue to operate under the $250,000 threshold, whereas an institution whose problems are attributable to poor underwriting of real estate loans may be subjected to a lower threshold.

However, regardless of an institution's condition, an examiner may determine that a particular real estate-related financial transaction requires a Title XI appraisal. This provision confirms that the agencies have the authority to require appraisals for a particular transaction to address safety and soundness concerns.

A determination that a particular institution will have to obtain appraisals below the threshold will be made by the appropriate agency's supervisory office. Although this provision is intended to be applied on a case-by-case basis to address the problems of a particular institution, the agencies will work to maintain consistency.

As previously stated in the discussion of the appraisal threshold, as a matter of policy, OTS intends to require problem institutions or institutions in troubled condition to continue to obtain Title XI appraisals for loans over $100,000. Given the overall concentration of real estate-related transactions in the thrift industry, OTS believes that a problem thrift or a thrift in troubled condition will, in general, have real estate-related asset quality problems.

§ __.4(a) Minimum Appraisal Standards

The agencies are adopting five minimum appraisal standards in place of the 14 standards in the prior rule. The final rule includes four modifications to the proposed rule concerning

minimum appraisal standards. The final rule requires all appraisals for federally related transactions to:

(i) Conform to generally accepted appraisal standards as evidenced by the USPAP unless principles of safe and sound banking require compliance with stricter standards;

(ii) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(iii) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(iv) Be based upon the definition of market value as set forth in the regulation; and

(v) Be performed by State licensed or certified appraisers.

Adoption of these standards will simplify compliance with the appraisal regulation without affecting the usefulness of the Title XI appraisals prepared for federally related transactions. The amendment allows institutions to make use of the USPAP Departure Provision and eliminates several regulatory standards that parallel existing USPAP standards.

The agencies proposed three alternatives for meeting the statutory requirement to use the USPAP in setting minimum appraisal standards for federally related transactions. Under the first two alternatives, the agencies would have published the USPAP as part of their regulations (either as an appendix to their

rules or through incorporation by reference). The agencies have chosen to adopt the third alternative that generally references USPAP, but does not make USPAP a part of the agencies' regulations. The agencies agree with many commenters who believed that Alternative III was the most workable approach because the agencies would not have to republish changes to the USPAP adopted by the Appraisal Standards Board, and references to USPAP in the regulation could be assumed to always refer to the most current USPAP edition. The agencies believe that Alternative III minimizes potential conflicts between an institution's duty to follow the agencies' appraisal requirements and an appraiser's professional obligation to follow the latest USPAP version.

Since the agencies are adopting Alternative III, USPAP provisions applicable to federally related transactions will no longer be published as Appendix A to the agencies' appraisal regulations. Therefore, each agency has deleted Appendix A from its appraisal regulation.

Because application of present or future USAP standards to federally related transactions may be inconsistent with maintaining the safety and soundness of financial institutions, the agencies have modified the standard on compliance with the USPAP. This modification makes clear that principles of safe and sound banking may require institutions to comply with stricter standards than the USPAP. Although the institution has the primary responsibility for obtaining a Title XI appraisal that meets its needs, the agencies may by regulation or guidance identify USPAP standards that are inappropriate for federally related transactions. For example, the USPAP allows an appraiser to appraise property even though the appraiser may have a direct or indirect interest in the property, if the appraiser discloses this

fact in the appraisal report. The agencies believe, however, that federal financial and public policy interests are better served by requiring that an appraiser for a federally related transaction not have any direct or indirect interest, financial or otherwise, in the transaction or the property. The agencies have included this requirement in the section of the regulation that deals with appraiser independence.

The minimum standards also permit regulated institutions to use appraisals prepared in accordance with the USPAP Departure Provision for federally related transactions. The Departure Provision permits limited exceptions to specific guidelines in the USPAP. Appraisers preparing appraisals using the Departure provision still must comply with all binding requirements of the USPAP and must be sure that the resulting appraisal will not be misleading.

The agencies believe that regulated institutions should be allowed to determine, with the assistance of the appraiser, whether an appraisal to be prepared in accordance with the Departure Provision is appropriate for a particular transaction and consistent with principles of safe and sound banking practice.

The agencies are adopting a modified version of the proposed standard that requires appraisals for federally related transactions to be written. The modification makes clear that the written appraisal must contain sufficient information and analysis to support the institution's decision to engage in the transaction. The modification puts regulated institutions on notice of their responsibility to have appraisals that are appropriate for the particular federally related transaction. The agencies are aware that the Appraisal Standards Board of the Appraisal Foundation has proposed changing the USPAP to

expand the types of appraisal reports that appraisers may prepare. The agencies believe that the standard on written appraisals permits regulated institutions to take advantage of additional flexibility that may be available if the USPAP is amended, as long as the appraisal report contains information and analysis to support the institution's decision.

The agencies are retaining from the prior rule the standard regarding deductions and discounts. The USPAP provision on this subject requires the appraiser to include a discussion of deductions and discounts only when it is necessary to prevent an appraisal from being misleading. Although commenters were divided over the need to retain this regulatory standard, the agencies have decided that it is appropriate to emphasize the need to include an appropriate discussion of deductions and discounts applicable to the estimate of value in Title XI appraisals for federally related transactions.

For example: in order to properly underwrite a loan, a regulated institution may need to know a prospective value of a property, in addition to the market value as of the date of the appraisal. A prospective value of a property is based upon events yet to occur, such as completion of construction or renovation, reaching a stabilized occupancy level, or some other event to be determined. Thus, more than one value may be reported in an appraisal, as long as all values are clearly described and reflect the projected dates when future events could occur.

The standard on deductions and discounts is intended to make clear that appraisers must analyze, apply, and report appropriate discounts and deductions when providing values based on future events. In financing the purchase of an existing home, there typically would be no need to apply any discounts or

deductions to arrive at the market value of the property since the institution's financing of the project does not depend on events such as further development of the property or the sale of units in a tract development.

In place of the proposed standard on market value, the agencies are retaining the prior standard that required the appraisal be based on the definition of market value contained in the agencies' rules. Use of the standard from the prior rule is intended to emphasize that the agencies are not changing the definition of market value or the manner in which that definition is applied.

The agencies are eliminating regulatory standards that parallel or duplicate requirements of the USPAP. The regulatory standards originally were put in place because of uncertainty about the content of the USPAP and its interpretation. Based on their experience with the USPAP, the agencies believe that the additional standards may be eliminated. Commenters generally agreed. The majority of commenters responded to three specific questions on the need for additional regulatory standards by indicating that it was unnecessary to adopt separate standards on: (i) Analysis of revenues, expenses and vacancies; (ii) valuation of personal property; and (iii) reconciliation of the three approaches to value. The elimination of regulatory standards that parallel USPAP standards should simplify the preparation of appraisals for federally related transactions and reduce regulatory burden.

As proposed, the agencies are adding a new provision to make clear that all appraisals for federally related transactions must be prepared by licensed or certified appraisers. This requirement is mandated by Title XI of FIRREA and repeated in other parts of the appraisal regulation.

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§ __.4(b/c) Unavailability of Information [Removed]

The agencies are removing the provision that required appraisers to disclose and explain when information necessary to the completion of an appraisal is unavailable. The USPAP currently requires appraisers to disclose and explain the absence of information necessary to completion of an appraisal that is not misleading. See USPAP Standard Rule 2-2-(k). Moreover, when information that may materially affect the estimate of value is unavailable, the agencies believe that generally accepted appraisal standards require appraisers to explain the absence of that information and its effect on the reliability of the appraisal. Therefore, eliminating this provision does not result in a substantive change in the requirements applicable to appraisals for federally related transactions.

§ __.4(c/d) Additional Standards (Removed)

The agencies are removing a provision that merely confirmed the authority of regulated institutions to require appraisers they use to comply with additional standards. The regulation's minimum appraisal standards for federally related transactions do not prevent a regulated institution from requiring an appraiser to follow additional standards or provide additional information to satisfy the institution's business needs and it is unnecessary to restate this fact in the appraisal regulation.

§ __.5(b) Appraiser Independence

The agencies are adopting the proposed amendment concerning the use of appraisals prepared for financial services institutions other than institutions subject to Title XI of FIRREA. The agencies' prior appraisal regulations provided that fee

appraisers must be engaged by the regulated institution or its agent. An exception to this requirement was permitted if the appraiser was directly engaged by another institution that is subject to Title XI of FIRREA.

The agencies concluded that the prior provision on the use of appraisals prepared for other institutions was too restrictive. It required a regulated institution to obtain a new appraisal if the borrower originally sought a loan from an institution that was not subject to Title XI of FIRREA and was not an agent of that regulated institution. There also was uncertainty about the meaning of agent in these cases.

The amended provision permits a regulated institution to use an appraisal that was prepared for any financial services institution, including mortgage bankers, if certain conditions are met. The appraiser must be engaged directly by the financial services institution and must not have a direct interest, financial or otherwise, in the property or the transaction. In addition, the regulated institution must ensure that the appraisal conforms to the requirements of the regulation and is otherwise acceptable. The prohibition on the institution using an appraisal prepared for the borrower remains in effect.

The majority of comments concerning this provision favored the proposed change. One commenter requested that the agencies define financial services institutions and include mortgage brokers within that definition. Other commenters requested clarification of the circumstances under which a nonregulated institution can be an agent of a regulated institution and whether agents are prohibited from receiving a commission on each transaction.

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The agencies have decided not to adopt a specific definition of financial services institution. This term is intended to describe entities that provide services in connection with real estate lending transactions on an ongoing basis.

The agencies do not intend to limit the arrangements that regulated institutions have with their agents, provided those arrangements do not place the agent in a conflict of interest that prevents the agent from representing the interests of the regulated institution. For example, the agencies do not require that there be a written agreement between the regulated institution and the agent, and the agent may represent the regulated institution solely with respect to ordering appraisals. In addition, the agencies' regulations do not prohibit agents from receiving a commission for transactions on which they order appraisals.

Some commenters opposed the amendment because of their concern that it would increase the pressure on appraisers to render an estimate of value that favors the interests of the borrower. However, regulated institutions are not required to accept appraisals that are prepared for other financial services institutions. Therefore, the institution always retains complete control over the process of ordering real estate appraisals. In addition, institutions must determine that the appraisal ordered by the financial services institution complies with the requirements of the agencies' regulations and is otherwise acceptable. This should include obtaining assurance that the financial services institution has an independent appraisal.

Other suggested changes to reduce the burden on secondary market transactions involving real estate notes, particularly for mortgage warehousing loans, are addressed in the exemption for transactions in real estate notes.

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IV. Waiver of Delayed Effective Date

This final rule is effective on June 7, 1994. The 30-day delayed effective date required under the Administrative Procedure Act (APA) is waived pursuant to 5 U.S.C. 553(d)(1), which provides for waiver when a substantive rule grants or recognizes an exemption or relieves a restriction. The amendments adopted in this final rule exempt additional transactions from the appraisal regulation, reduce appraisal standards, and provide other modifications that have the effect of relieving perceived restrictions. Consequently, all amendments in this final rule meet the requirements for waiver set forth in the APA.

V. Paperwork Reduction Act

OCC Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1557-0190. The estimated annual burden per recordkeeper ranges from 0 hours to in excess of 100 hours, depending on individual circumstances, with an estimated average of 34.5 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Comptroller of the Currency, Legislative, Regulatory, and International Activities, Attention: 1557-0190, 250 E Street SW., Washington, DC 20219, and to the Office of Management and Budget, Paperwork Reduction Project (1557-0190), Washington, DC 20503.

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Board Paperwork Reduction Act

The Board is adopting revisions to Regulation Y in this rulemaking that relate to recordkeeping requirements under authority delegated to it by the Office of Management and Budget, in accordance with section 3507 of the Paperwork Reduction Act of 1980, 44 U.S.C. chapter 35, and part 1320 of title 5, Code of Federal Regulations, 5 CFR part 1320. In developing these revisions, the Board has consulted with the OCC, the FDIC, and the OTS.

The collection of information in this regulation is in 12 CFR part 225. This information is required by the Federal Reserve System to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. State member banks will use this information in determining whether and on what terms to enter into federally related transactions, such as making loans secured by real estate. The Federal Reserve System will use this information in its examination of State member banks and bank holding companies to ensure that they undertake real estate-related financial transactions in accordance with safe and sound banking principles.

The likely recordkeepers are for-profit institutions.

The estimated annual burden per recordkeeper varies from 0 hours to in excess of 100 hours, depending on individual circumstances, with an estimated average of 25.1 hours. Estimated number of recordkeepers: 1573.

FDIC Paperwork Reduction Act

The collection of information contained in this final rule has

been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1980 (44 U.S.C. 3504(h)). Comments on the collection of information should be sent to the Assistant Executive Secretary (Administration), room F-400, 550 17th Street, NW., Washington, DC 20429, with a copy to the Office of Management and Budget, Paperwork Reduction Project 3064-103, Washington, DC 20503.

The collection of information in this final rule is in 12 CFR part 323. This information is required by the FDIC to protect federal financial and public policy interests in real estate-related financial transactions requiring the services of an appraiser. State nonmember banks will use this information in determining whether and on what terms to enter into federally related transactions, such as making loans secured by real estate. The FDIC will use this information in its examination of State nonmember banks to ensure that they undertake real estate-related financial transactions in accordance with safe and sound banking principles.

The likely recordkeepers are for-profit institutions.

The estimated annual burden per recordkeeper varies from 0 hours to in excess of 100 hours, depending on individual circumstances, with an estimated average of 20.0 hours. Estimated number of recordkeepers: 7,310.

OTS Paperwork Reduction Act

The collection of information contained in this final regulation has been reviewed and approved by the Office of Management and Budget in accordance with the requirements of

the Paperwork Reduction Act (44 U.S.C. 3504(h)) under control number 1550. The estimated annual burden per recordkeeper ranges from 0 hours to in excess of 100 hours, depending on individual circumstances, with an estimated average of 59 hours.

Comments concerning the accuracy of this burden estimate and suggestions for reducing this burden should be directed to the Office of Management and Budget, Paperwork Reduction Project (1550), Washington, DC 20503, with copies to the Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552.

VI. OCC and OTS Executive Order 12866 Determination

It has been determined that this final rule is not a "Significant Regulatory Action" under Executive Order 12866.

List of Subjects

12 CFR Part 34

Mortgages, National banks, Real estate appraisals, Real estate lending standards, Reporting and recordkeeping requirements.

12 CFR Part 225

Administrative practice and procedure, Banks, banking, Holding companies, Reporting and recordkeeping requirements, Securities.

12 CFR Part 323

Banks, banking, Mortgages, Real estate appraisals,

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Reporting and recordkeeping requirements, State nonmember insured banks.

12 CFR Part 545

Accounting, Consumer protection, Credit, Electronic funds transfers, Investments, Manufactured homes, Mortgages, Reporting and recordkeeping requirements, Savings associations.

12 CFR Part 563

Accounting, Advertising, Crime, Currency, Flood insurance, Investments, Reporting and recordkeeping requirements, Savings associations, Securities, Surety bonds.

12 CFR Part 564

Appraisals, Real estate appraisals, Reporting and recordkeeping requirements, Savings associations.

COMPTROLLER OF THE CURRENCY

12 CFR Chapter I

Authority and Issuance

For the reasons set out in the joint preamble, part 34 of chapter I of title 12 of the Code of Federal Regulations is amended as set forth below:

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PART 34—REAL ESTATE LENDING AND APPRAISALS

1. The authority citation for part 34 continues to read as follows:

Authority: 12 U.S.C. 1 *et seq.*, 93a, 371, 1701j-3, 1828(o), and 3331 et seq.

2. In § 34.42, existing paragraphs (d) through (l) are redesignated as paragraphs (e) through (m), respectively, and a new paragraph (d) is added to read as follows:

§ 34.42 Definitions.

* * * * *

(d) *Business loan* means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

* * * * *

3. In § 34.43, paragraph (a) is revised, paragraphs (b) through (d) are redesignated as paragraphs (d) through (f), respectively, and new paragraphs (b) and (c) are added to read as follows:

§ 34.43 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) *Appraisals required.* An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

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(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment

in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met OCC regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency; or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or

(12) OCC determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) *Evaluations required.* For a transaction that does not require the services of a State certified or licensed appraiser under paragraph (a)(1), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property

collateral that is consistent with safe and sound banking practices.

(c) *Appraisals to address safety and soundness concerns.* The OCC reserves the right to require an appraisal under this subpart whenever the agency believes it is necessary to address safety and soundness concerns.

* * * * *

4. Section 34.44 is revised to read as follows:

§ 34.44 Minimum appraiser standards.

For federally related transactions, all appraisals shall, at a minimum:.

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this subpart; and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this subpart.

5. In § 34.45, paragraph (b) is revised to read as follows:

§ 34.45 Appraiser independence.

* * * * *

(b) *Fee appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if:

(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this subpart and is otherwise acceptable.

Appendix A to Subpart C [Removed]

6. Appendix A to subpart C, part 34 is removed.

Dated: March 31, 1994

Eugene A. Ludwig,

Comptroller of the Currency

Appendix R

FEDERAL RESERVE SYSTEM

12 CFR Chapter II

For the reasons set forth in the common preamble, the Board amends 12 CFR part 225 as set forth below:

PART 225—BANK HOLDING COMPANIES AND CHANGE IN BANK CONTROL (REGULATION Y)

1. The authority citation for part 225 is revised to read as follows:

Authority; 12 U.S.C. 1817(j)(13), 1818, 1831i, 1843(c)(8), 1844(b), 1972(l), 3106, 3108, 3310, 3331-3351, 3907, and 3909.

2. Section 225.62 is amended by redesignating paragraphs (d) through (f) and paragraphs (g) through (k) as paragraphs (e) through (g) and paragraphs (i) through (m), respectively, and adding new paragraphs (d) and (h) to read as follows:

§ 225.62 Definitions.

* * * * *

(d) *Business loan* means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

* * * * *

(h) *Real estate or real property* means an identified parcel

or tract of land, with improvements, and includes easements, rights of way, undivided or future interests, or similar rights in a tract of land, but does not include mineral rights, timber rights, growing crops, water rights, or similar interests severable from the land when the transaction does not involve the associated parcel or tract of land.

* * * * *

3. Section 225.63 is amended by revising the section heading, revising paragraph (a), redesignating paragraphs (b) and (c) as paragraphs (d) and (e) and adding new paragraphs (b) and (c) to read as follows:

§ 225.63 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) *Appraisals required.* An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met Board regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency; or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or

(12) The Board determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) *Evaluations required.* For a transaction that does not require the services of a State certified or licensed appraiser under paragraph (a)(l), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

(c) *Appraisals to address safety and soundness concerns.* The Board reserves the right to require an appraisal under this subpart whenever the agency believes it is necessary to address safety and soundness concerns.

* * * * *

4. Section 225.64 is revised to read as follows:

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§ 225.64 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington, DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this subpart; and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this subpart.

5. Section 225.65 is amended by revising paragraph (b) to read as follows:

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§ 225.65 Appraiser independence.

* * * * *

(b) *Fee appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if:

(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this subpart and is otherwise acceptable.

Appendix A to Subpart G [Removed]

6. Appendix A to subpart G, part 225, is removed.

Dated: May 25, 1994.

William W. Wiles,

Secretary of the Board.

Appendix R

FEDERAL DEPOSIT INSURANCE CORPORATION

12 CFR Chapter III

Authority and Issuance

For the reasons set out in the joint preamble, part 323 of subchapter B of chapter III of title 12 of the Code of Federal Regulations is amended as set forth below:

PART 323—APPRAISALS

1. The authority citation for part 323 is revised to read as follows:

Authority: 12 U.S.C. 1818,1819 ["Seventh" and "Tenth"], and 3331-3352.

2. Section 323.2 is amended by redesignating paragraphs (d) through (l) as paragraphs (e) through (m), respectively, and adding a new paragraph (d) to read as follows:

§ 323.2 Definitions.

* * * * *

(d) *Business loan* means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

* * * * *

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3. Section 323.3 is amended by revising the section heading and paragraph (a), revising the phrase in paragraph (d) "paragraphs (b) and (c) of this section" to read "this section", redesignating paragraphs (b) through (d) as paragraphs (d) through (f), respectively, and adding new paragraphs (b) and (c) to read as follows:

§ 323.3 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) *Appraisals required.* An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met FDIC regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency; or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary

capacity and is not required to obtain an appraisal under other law; or

(12) The FDIC determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) *Evaluations required.* For a transaction that does not require the services of a State certified or licensed appraiser under paragraph (a)(1), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

(c) *Appraisals to address safety and soundness concerns.* The FDIC reserves the right to require an appraisal under this part whenever the agency believes it is necessary to address safety and soundness concerns.

* * * * *

4. Section 323.4 is revised to read as follows:

§ 323.4 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW.,

Washington DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this part; and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this part.

5. Section 323.5 is amended by revising paragraph (b) to read as follows:

§ 323.5 Appraiser Independence.

* * * * *

(b) *Fee appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest, financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if:

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(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this part and is otherwise acceptable.

Appendix IX [Removed]

6. Appendix A to Part 323 is removed.

By order of the Board of Directors.

Dated at Washington, DC, this 3rd day of May 1994.

Federal Deposit Insurance Corporation.

Robert E. Feldman,

Acting Executive Secretary

OFFICE OF THRIFT SUPERVISION

12 CFR Chapter V

Authority and Issuance

Accordingly, for the reasons set forth in the joint preamble, the Office of Thrift Supervision hereby amends chapter V, title 12 of the Code of Federal Regulations, as set forth below:

Appendix R

Subchapter C—Regulations for Federal Savings Associations

PART 545—OPERATIONS

1. The authority citation for part 545 continues to read as follows:

Authority: 12 U.S.C. 1462a, 1463,1464, 1828.

2. Section 545.32 is amended by revising the first sentence of paragraph (b)(2) to read as follows:

§ 545.32 Real estate loans.

* * * * *

(b) * * *

(2) *Appraisals.* A Federal savings association may make a real estate loan only after an appraiser has submitted a signed appraisal of the security property consistent with the requirements of part 564 of this chapter. * * *

* * * * *

3. Section 545.103 is amended by revising the second sentence of paragraph (b) to read as follows:

§ 545.103 Suretyship.

* * * * *

(b) * * * If real estate, the value must be established by a

signed appraisal consistent with the requirements of part 564 of this chapter. * * *

* * * * *

Subchapter D—Regulations Applicable to All Savings Associations

PART 563—OPERATIONS

4. The authority citation for part 563 continues to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1467, 1468, 1817, 1818, 3806; 42 U.S.C. 4106; Pub. L. 102-242, sec. 306, 105 Stat. 2236, 2335 (1991)

5. Section 563.170 is amended by revising paragraph (c)(1)(iv) to read as follows:

§ 563.170 Examinations and audits; appraisals; establishment and maintenance of records.

* * * * *

(c) * * *

(1) * * *

(iv) One or more written appraisal reports, prepared at the request of the lender or its agent and for the lender's use, and signed prior to the approval of such application (except in the case of an approval conditioned upon obtaining an appraisal) that

satisfies the requirements of part 564 of this chapter: *Provided, however,* That nothing in this paragraph (c)(1)(iv) shall apply to property improvement loans, as that term is used in 24 CFR 200.167, insured by the Federal Housing Administration for which that agency does not require an appraisal or certification of valuation;

* * * * *

PART 564—APPRAISALS

6. The authority citation for part 564 is revised to read as follows:

Authority: 12 U.S.C. 1462, 1462a, 1463, 1464, 1828(m), 3331 *et seq.*

7. Section 564.2 is amended by redesignating paragraphs (d) through (l) as paragraphs (e) through (m), respectively, and by adding a new paragraph (d) to read as follows:

§ 564.2 Definitions

* * * * *

(d) *Business loan* means a loan or extension of credit to any corporation, general or limited partnership, business trust, joint venture, pool, syndicate, sole proprietorship, or other business entity.

* * * * *

8. Section 564.3 is amended by revising paragraph (a),

redesignating paragraphs (b) through (d) as paragraphs (d) through (f), and adding new paragraphs (b) and (c) to read as follows:

§ 564.3 Appraisals required; transactions requiring a State certified or licensed appraiser.

(a) *Appraisals required.* An appraisal performed by a State certified or licensed appraiser is required for all real estate-related financial transactions except those in which:

(1) The transaction value is $250,000 or less;

(2) A lien on real estate has been taken as collateral in an abundance of caution;

(3) The transaction is not secured by real estate;

(4) A lien on real estate has been taken for purposes other than the real estate's value;

(5) The transaction is a business loan that:

(i) Has a transaction value of $1 million or less; and

(ii) Is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment;

(6) A lease of real estate is entered into, unless the lease is the economic equivalent of a purchase or sale of the leased real estate;

(7) The transaction involves an existing extension of credit at the lending institution, provided that:

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(i) There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the institution's real estate collateral protection after the transaction, even with the advancement of new monies; or

(ii) There is no advancement of new monies, other than funds necessary to cover reasonable closing costs;

(8) The transaction involves the purchase, sale, investment in, exchange of, or extension of credit secured by, a loan or interest in a loan, pooled loans, or interests in real property, including mortgaged-backed securities, and each loan or interest in a loan, pooled loan, or real property interest met OTS regulatory requirements for appraisals at the time of origination;

(9) The transaction is wholly or partially insured or guaranteed by a United States government agency or United States government sponsored agency;

(10) The transaction either:

(i) Qualifies for sale to a United States government agency or United States government sponsored agency, or

(ii) Involves a residential real estate transaction in which the appraisal conforms to the Federal National Mortgage Association or Federal Home Loan Mortgage Corporation appraisal standards applicable to that category of real estate;

(11) The regulated institution is acting in a fiduciary capacity and is not required to obtain an appraisal under other law; or

(12) The OTS determines that the services of an appraiser are not necessary in order to protect Federal financial and public policy interests in real estate-related financial transactions or to protect the safety and soundness of the institution.

(b) *Evaluations required.* For a transaction that does not require the services of a State certified or licensed appraiser under paragraph (a)(1), (a)(5) or (a)(7) of this section, the institution shall obtain an appropriate evaluation of real property collateral that is consistent with safe and sound banking practices.

(c) *Appraisals to address safety and soundness concerns.* The OTS reserves the right to require an appraisal under this part whenever the agency believes it is necessary to address safety and soundness concerns.

* * * * *

9. Section 564.4 is revised to read as follows:

§ 564.4 Minimum appraisal standards.

For federally related transactions, all appraisals shall, at a minimum:

(a) Conform to generally accepted appraisal standards as evidenced by the Uniform Standards of Professional Appraisal Practice (USPAP) promulgated by the Appraisal Standards Board of the Appraisal Foundation, 1029 Vermont Ave., NW., Washington DC 20005, unless principles of safe and sound banking require compliance with stricter standards;

(b) Be written and contain sufficient information and analysis to support the institution's decision to engage in the transaction;

(c) Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units;

(d) Be based upon the definition of market value as set forth in this part: and

(e) Be performed by State licensed or certified appraisers in accordance with requirements set forth in this part.

10. Section 564.5 is amended by revising paragraph (b) to read as follows:

§ 564.5 Appraiser independence.

* * * * *

(b) *Fee appraisers.* (1) If an appraisal is prepared by a fee appraiser, the appraiser shall be engaged directly by the regulated institution or its agent, and have no direct or indirect interest financial or otherwise, in the property or the transaction.

(2) A regulated institution also may accept an appraisal that was prepared by an appraiser engaged directly by another financial services institution, if

(i) The appraiser has no direct or indirect interest, financial or otherwise, in the property or the transaction; and

(ii) The regulated institution determines that the appraisal conforms to the requirements of this part and is otherwise acceptable.

§ 564.8 [Amended]

11. Section 564.8 is amended by removing paragraph (d)(1), by removing the colon following the introductory text of paragraph (d), by revising the word "Appraisals" to read "appraisals" in paragraph (d)(2), and by removing the paragraph designation (d)(2).

Appendix A [Removed]

12. Appendix A to Part 564 is removed.

Dated: April 6, 1994.

By the Office of Thrift Supervision.

Jonathan L. Fiechter,

Acting Director

[FR Doc. 94-13312 Filed 6-6-94; 8:45 am]

BILLING CODE 4810-33-P, 6210-01-P, 6714-01-P, 6720-01-P

APPENDIX S — ANNUAL INDEPENDENT AUDITS AND REPORTING REQUIREMENTS, PART 363, JUNE 2, 1993

PART 363—ANNUAL INDEPENDENT AUDITS AND REPORTING REQUIREMENTS

Sec.

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AUTHORITY: 12 U.S.C. 1831 m.

SOURCE: The provisions of this Part 363 appear at 58 Fed. Reg. 31335, June 2, 1993, effective July 2, 1993, except as otherwise noted.

§ 363.0 OMB control number.

The collecting of information requirements in this part have been approved by the Office of Management and Budget under OMB control number 3064-0113.

[Codified to 12 C.F.R. § 363.0]

§ 363.1 Scope.

(a) *Applicability.* This part applies with respect to fiscal years of insured depository institutions which begin after December 31, 1992. This part does not apply with respect to any fiscal year of any insured depository institution, the total assets of

which, at the beginning of such fiscal year, are less than $500 million.

(b) *Compliance by subsidiaries of holding companies.* The audited financial statements requirement of § 363.2(a) may be satisfied for an insured depository institution that is a subsidiary of a holding company by audited financial statements of the consolidated holding company. The other requirements of this part for an insured depository institution that is a subsidiary of a holding company may be satisfied by the holding company if:

(1) The services and functions comparable to those required of the insured depository institution by this part are provided at the holding company level; and

(2) Either the insured depository institution has total assets as of the beginning of such fiscal year of:

(i) Less than $5 billion; or

(ii) More than $5 billion, but less than $9 billion, and a composite CAMEL (or MACRO, or equivalent) rating of 1 or 2.

[Codified to 12 C.F.R. § 363.1]

§ 363.2 Annual reporting requirements.

(a) *Audited financial statements.* Each insured depository institution shall prepare annual financial statements in accordance with generally accepted accounting principles which shall be audited by an independent public accountant.

(b) *Management report.* Each insured depository

institution annually shall prepare, as of the end of the institution's most recent fiscal year, a management report signed by its chief executive officer and chief accounting or chief financial officer which contains:

(1) A statement of management's responsibilities for preparing the institution's annual financial statements, for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and for complying with laws and regulations relating to safety and soundness which are designated by the FDIC and the appropriate federal banking agency; and

(2) Assessments by management of the effectiveness of such internal control structure and procedures as of the end of such fiscal year and the institution's compliance with such laws and regulations during such fiscal year.

[Codified to 12 C.F.R. § 363.2]

§ 363.3 Independent public accountant.

(a) *Annual audit of financial statement.* Each insured depository institution shall engage an independent public accountant to audit and report on its annual financial statements in accordance with generally accepted auditing standards and section 37 of the Federal Deposit Insurance Act (12 U.S.C. 1831n). The scope of the audit engagement shall be sufficient to permit such accountant to determine and report whether the financial statements are presented fairly and in accordance with generally accepted accounting principles.

(b) *Additional reports.* Such independent public accountant shall examine, attest to, and report separately on, the assertions of management concerning the institution's internal control structure and procedures for financial reporting. The accountant shall apply procedures agreed upon by the FDIC objectively to determine compliance by an insured depository institution with designated laws and regulations. The attestations shall be made in accordance with generally accepted standards for attestation engagements.

(c) *Notice by accountant of termination of services.* An independent public accountant performing an audit under this part who ceases to be the accountant for an insured depository institution shall notify the FDIC and the appropriate federal banking agency in writing of such termination within 15 days after the occurrence of such event, and set forth in reasonable detail the reasons for such termination.

[Codified to 12 C.F.R. § 363.3]

§ 363.4 Filing and notice requirements.

(a) *Annual reporting.* Within 90 days after the end of its fiscal year, each insured depository institution shall file with each of the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, two copies of:

(1) An annual report containing audited annual financial statements, the independent public accountant's report thereon, management's statements and assessments, and the independent public accountant's attestation report concerning the institution's internal control structure and procedures for financial reporting as required by §§ 363.2(a) and 363.3(a), 363.2(b), and 363.3(b) respectively, and

(2) The accountant's attestation concerning compliance with laws and regulations pursuant to 363.3(b).

(b) *Public availability.* The foregoing annual report in paragraph (a) of this section shall be available for public inspection.

(c) *Independent accountant's reports.* Each insured depository institution shall file with the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor, a copy of any management letter, qualification, or other report issued by its independent public accountant with respect to such institution and the services provided by such accountant pursuant to this part within 15 days after receipt.

(d) *Notice of engagement or change of accountants.* Each insured depository institution shall provide, within 15 days after the occurrence of any such event, written notice to the FDIC, the appropriate federal banking agency, and any appropriate state bank supervisor of the engagement of an independent public accountant, or the resignation or dismissal of the independent public accountant previously engaged. The notice shall include a statement of the reasons for any such event in reasonable detail.

[Codified to 12 C.F.R. § 363.4]

§ 363.5 Audit committees.

(a) *Composition and duties.* Each insured depository institution shall establish an independent audit committee of its board of directors, the members of which shall be outside directors who are independent of management of the institution, and the duties of which shall include reviewing with management

and the independent public accountant the basis for the reports issued under this part.

(b) *Committees of large institutions.* The audit committee of any insured depository institution that has total assets of more than $3 billion, measured as of the beginning of each fiscal year, shall include members with banking or related financial management expertise, have access to its own outside counsel, and not include any large customers of the institution.

[Codified to 12 C.F.R. § 363.5]

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Introduction

Congress added section 36, "Early Identification of Needed Improvements in Financial Management" (section 36), to the Federal Deposit Insurance Act (FDI Act) as part of the Federal Deposit Insurance Improvement Act of 1991, which became law on December 19, 1991 .

The FDIC adopted 12 CFR Part 363 of its rules and regulations (this part), effective July 2, 1993, to implement those provisions of section 36 that require rulemaking. Simultaneously, the FDIC Board of Directors approved these "Guidelines and Interpretations" (the Guidelines) and directed that they be published as an appendix to this part to facilitate a better understanding of, and full compliance with, the provisions of section 36.

The Guidelines were developed by the FDIC, in consultation with the other appropriate federal banking agencies, after careful consideration of the comments received on the proposed rule.

Although not contained in this part, some of the guidance

offered restates or refers to statutory requirements of section 36 and is therefore mandatory. If that is the case, the statutory provision is cited. The FDIC continues to believe, as stated in its "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), that every insured depository institution, regardless of its size or charter, should have an annual audit of its financial statements performed by an independent public accountant, and should establish an audit committee comprised entirely of outside directors.

The following Guidelines reflect the views of the FDIC concerning the interpretation of section 36. The Guidelines are intended to assist insured depository institutions (institutions), their boards of directors, and their advisors, including their independent public accountants and legal counsel, and to clarify section 36 and this part. It is recognized that reliance on the Guidelines may result in compliance with section 36 and this part which may vary from institution to institution. Terms which are not explained in the Guidelines have the meanings given them in this part, the FDI Act or professional accounting and auditing literature.

Scope of Rule (§ 363.1)

1. *Measuring Total Assets.* To determine whether this part applies, an institution should use total assets as reported on its most recent Report of Condition (Call Report) or Thrift Financial Report (TFR), the date of which coincides with the end of its preceding fiscal year. If its fiscal year ends on a date other than the end of a calendar quarter, it should use its Call Report or TFR for the quarter end immediately preceding the end of its fiscal year.

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2. *Insured Branches of Foreign Banks.* Unlike other institutions, insured branches of foreign banks are not separately incorporated or capitalized. To determine whether this part applies, an insured branch should measure claims on non-related parties reported on its Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks (form FFIEC 002).

3. *Compliance by Holding Company Subsidiaries.* Audited consolidated financial statements and other reports or notices required by this part which are submitted by a holding company for any subsidiary institution, should be accompanied by a cover letter identifying all subsidiary institutions to which they pertain. An institution filing holding company consolidated financial statements as permitted by § 363.1(b) also may report on changes in its independent public accountant on a holding company basis. An institution that does not meet the criteria in section 36(i) must satisfy the remaining provisions of the statute and this part on an individual institution basis, and maintain its own audit committee. Multi-tiered holding companies may satisfy all requirements of this part at any level.

4. *Comparable Services and Functions.* Services and functions will be considered "comparable" to those required by this part if the holding company:

(a) Prepares reports used by the subsidiary institution to meet the requirements of this part;

(b) Has an audit committee that meets the requirements of this part appropriate to its largest subsidiary institution; and

(c) Prepares and submits the management assessments of the effectiveness of the internal control structure and procedures

for financial reporting (internal controls), and compliance with the designated laws defined in guideline 12 that are based on information concerning the activities and operations of all subsidiary institutions within the scope of this part.

Annual Reporting Requirements (§ 363.2)

5. *Annual Financial Statements.* Each institution should prepare comparative annual consolidated financial statements (balance sheets, statements of income, changes in equity capital, and cash flows, with accompanying footnote disclosures) in accordance with generally accepted accounting principles (GAAP) for each of its two most recent fiscal years. Statements for the earlier year may be presented on an unaudited basis if the institution was not subject to this part for that year and audited statements were not prepared.

6. *Holding Company Statements.* Subsidiary institutions may file copies of their holding company's audited financial statements filed with the Securities and Exchange Commission (SEC) or prepared for their FR Y-6 Annual Report under the Bank Holding Company Act of 1956.

7. *Insured Branches of Foreign Banks.* An insured branch of a foreign bank should satisfy the financial statements requirement by filing one of the following for the two preceding fiscal years:

(a) Audited balance sheets, disclosing information about financial instruments with off-balance-sheet risk;

(b) Schedules RAL and L of form FFIEC 002, prepared and audited on the basis of the instructions for its preparation; or

(c) With written approval of the appropriate federal banking agency, consolidated financial statements of the parent bank.

8. *Management Report.* Management should perform its own investigation and review of the effectiveness of internal controls and compliance with the Designated Laws defined in guideline 12. Management also should maintain records of its determinations and assessments until the next federal safety and soundness examination, or such later date as specified by the FDIC or appropriate federal banking agency. Management should provide in its assessment of the effectiveness of internal controls and compliance with the Designated Laws, or supplementally, sufficient information to enable the accountant to report on its assertions. The management report of an insured branch of a foreign bank should be signed by the branch's managing official if the branch does not have a chief executive or financial officer.

9. *Safeguarding of Assets.* The FDIC believes "safeguarding of assets," as the term relates to internal control policies and procedures regarding financial reporting, and which has precedent in accounting literature, should be addressed in the management report and the independent public accountant's attestation discussed in guideline 16. It also believes that testing the existence of and compliance with internal controls on the management of assets, including loan underwriting and documentation, represents a reasonable implementation of section 36. Management should therefore address such internal controls as part of its management report, and the accountant should test compliance with them. Recognizing the lack of objective criteria against which the accountant may judge safeguarding of assets, however, the FDIC does not require the

accountant to attest to the adequacy of safeguards, but only to determine whether safeguarding policies exist, and whether management has implemented them.[1]

10. *Standards for Internal Controls.* Each institution should determine its own standards for establishing, maintaining and assessing the effectiveness of its internal controls.[2]

11. *Service Organizations.* Although service organizations should be considered in determining if internal controls are adequate, an institution's independent public accountant, its management, and its audit committee should exercise independent judgment concerning that determination. Onsite reviews of service organizations may not be necessary to prepare

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1. It is management's responsibility to establish underwriting policies and to make credit decisions. The auditor's role is to test compliance with management's policies.

2. In considering what information is needed on safeguarding of assets and standards for internal controls, management may review guidelines provided by its primary federal regulator; the Federal Financial Institutions Examination Council's "Supervisory Policy Statement on Securities Activities", the FDIC's "Statement of Policy Providing Guidance on External Auditing Procedure for State Nonmember Banks" (Jan. 16, 1990), "Statement of Policy Regarding Independent External Auditing Programs of State Nonmember Banks" (Nov. 16, 1988), and Division of Supervision Manual of Examination Policies; the Federal Reserve Board's Commercial Bank Examination Manual and other relevant regulations; the Office of Thrift Supervision's Thrift Activities Handbook; the Comptroller of the Currency's Handbook for National Bank Examiners; standards published by professional accounting organizations, such as the *American Institute of Certified Public Accountant's (AICPA) Statement of Auditing Standards* No. 30, "Reporting on Internal Accounting Control"; and other internal control standards published by the AICPA, other accounting or auditing professional associations, and financial institution trade associations.

the reports required by the Rule, and the FDIC does not intend that the Rule establish any such requirement.

12. *Compliance with Laws and Regulations.* The designated laws and regulations are the federal laws and regulations concerning loans to insiders and the federal and state laws and regulations concerning dividend restrictions, which are more specifically identified in section 1 of the Agreed Upon Procedures referred to in guideline 19 (the Designated Laws).

Role of Independent Public Accountant (§ 363.3)

13. *General Qualifications. To* provide audit and attest services to insured depository institutions, an independent public accountant should be registered or licensed to practice as a public accountant, and be in good standing, under the laws of the state or other political subdivision of the United States in which the home office of the institution (or the insured branch of a foreign bank) is located. As required by section 36(g)(3)(A)(i), the accountant must agree to provide copies of any workpapers, policies, and procedures relating to services performed under this part.

14. *Independence.* The independent public accountant also should be in compliance with the AICPA's *Code of Professional Conduct* and meet the independence requirements and interpretations of the SEC and its staff.

15. *Peer Reviews.* As required by section 36(g)(3)(A)(ii), the independent public accountant must have received, or be enrolled in, a peer review that meets acceptable guidelines. The following peer review guidelines are acceptable:

(a) The external peer review should be conducted by an

organization independent of the accountant or firm being reviewed, as frequently as is consistent with professional accounting practices;

(b) The peer review should be generally consistent with AICPA standards;[3] and

(c) The review should include, if available, at least one audit on an insured depository institution or consolidated financial holding company. Peer review working papers are to be retained for 120 days after the peer review report is filed with the FDIC, and be made available to the FDIC upon request, in a form consistent with the SEC's agreement with the accounting profession.

16. *Filing Peer Review Reports.* Within 15 days of receiving notification that the peer review has been accepted, or before commencing any audit under this part, whichever is earlier, two copies of the peer review report, accompanied by any letter of comments and letter of response, should be filed by the independent public accountant with the FDIC, Registration and Disclosure Section, 550 17th Street N.W., Washington, D.C. 20429, where they will be available for public inspection. Accountants may elect to file an annual list of their insured depository institution and holding company (identifying any subsidiary institutions subject to this part) audit clients in lieu of copies of peer review reports for each institution they have been

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3. These would include Standards for Performing and Reporting on Peer Reviews, codified in the SEC Practice Section Reference Manual, Standards for Performing and Reporting on Quality Reviews, contained in Volume 2 of the AICPA's Professional Standards; or Standards for Performing and Reporting on Peer Reviews, of the AICPA's Private Companies Practice Section.

engaged to audit. The FDIC has determined that such client lists are exempt from public disclosure. All corrective action required under any qualified peer review report should have been taken prior to commencing services under this part.

17. *Information to Independent Public Accountant.* Attention is directed to section 36(h) which requires institutions to provide specified information to their accountants. An institution also should provide its accountant with copies of any notice that the institution's capital category is being changed or reclassified under section 38 of the FDI Act, and any correspondence from the appropriate federal banking agency concerning compliance with this part.

18. *Attestation Reports.* The independent public accountant should provide the institution with an internal controls attestation report, a compliance with Designated Laws attestation report, and any management letter, at the conclusion of the audit as required by section 36(c)(1). If a holding company subsidiary relies on its holding company management report, the accountant may attest to and report on the management's assertions in one report, without reporting separately on each subsidiary covered by this part. One attestation report for compliance with the designated laws also may be filed, if all exceptions are listed and the respective institutions to which the exceptions apply are identified. The FDIC has determined that management letters and the Designated Laws attestation report are exempt from public disclosure.

19. *Procedures for Determining Compliance with Designated Laws.* In order to permit the independent public accountant to determine the extent of compliance with the Designated Laws defined in guideline 12 and the related

assessment by management, the procedures set forth in schedule A (the Agreed Upon Procedures) to these Guidelines in this appendix should be applied. The accountant should require all management representations to be in writing, and take appropriate steps to determine that any sampling is reasonably representative. Attestation reports generally should identify all findings from application of the Agreed Upon Procedures which establish any items of non-compliance, note any absence of written policies, and disclose the reasons why any Agreed Upon Procedures were not performed.

20. *Reviews with Audit Committee and Management.* The independent public accountant should meet with the institution's audit committee to review the accountant's reports required by this part before they are filed. It also may be appropriate for the accountant to review its findings with the institution's board of directors and management.

21. *Notice of Termination.* The notice required by § 363.3(c) should state whether the independent public accountant agrees with the assertions contained in any notice filed by the institution under § 363.4(d), and whether the institution's notice discloses all relevant reasons.

22. *Reliance on Internal Auditors.* Nothing in this part or this appendix is intended to preclude the ability of the independent public accountant to rely on the work of an institution's internal auditor.

Filing and Notice Requirements (§ 363.4)

23. *Place for Filing.* Except for peer review reports filed pursuant to Guideline 16, all reports and notices required by, and

other communications or requests made pursuant to, this part should be filed as follows:

(a) FDIC: Regional Director (Supervision) of the FDIC Regional Office in which the institution is headquartered;

(b) Office of the Comptroller of the Currency (OCC): appropriate OCC Supervisory Office;

(c) Federal Reserve: appropriate Federal Reserve Bank;

(d) Office of Thrift Supervision (OTS): appropriate OTS District Office; and

(e) State bank supervisor: the filing office of the appropriate state bank supervisor.

24. *Relief from Filing Deadlines.* Although the FDIC believes that the deadlines for filings and other notices established by section 36 and this part are reasonable, it recognizes some institutions occasionally may be confronted with extraordinary circumstances beyond their reasonable control that may justify extensions of a deadline. In that event, upon written application from an insured depository institution, setting forth the reasons for any requested extension, the FDIC or appropriate federal banking agency may, for good cause shown, extend the deadline for a period not to exceed 30 days.

25. *Public Availability.* Each institution's annual report should be available for public inspection at its main and branch offices no later than 15 days after it is filed with the FDIC. Alternatively, an institution may elect to mail one copy of its annual report to any person who requests it. The annual report

should remain available to the public until the annual report for the next year is available. An institution may use its annual report under this part to meet the annual disclosure statement required by 12 CFR 350.3, if the institution satisfies all other requirements of 12 CFR Part 350.

26. *Independent Public Accountant's Reports.* Section 36(h)(2)(A) requires that, within 15 days of receipt by an institution of any management letter or other report, such letter or other report shall be filed with the FDIC, any appropriate federal banking agency, and any appropriate state bank supervisor. Institutions and their accountants are encouraged to coordinate preparation and delivery of audit and attestation reports and filing the annual report, to avoid duplicate filings.

27. *Notices Concerning Accountants.* Institutions should review and satisfy themselves as to compliance with the required qualifications set forth in guidelines 13-15 before engaging an independent public accountant. With respect to any selection, change or termination of an accountant, institutions should be familiar with the notice requirements in guideline 21, and should send a copy of any notice under § 363.4(d) to the accountant when it is filed with the FDIC. An institution which files reports with its appropriate federal banking agency under, or is a subsidiary of a holding company which files reports with the SEC pursuant to, the Securities Exchange Act of 1934 may use its current report *(e.g.,* SEC Form 8-K) concerning a change in accountant to satisfy the similar notice requirements of this part.

Audit Committees (§ 363.5)

28. *Composition.* The board of directors of each institution should determine if outside directors meet the requirements of

section 36 and this part. At least annually, it should determine whether all existing and potential audit committee members are "independent of management of the institution." If the institution has total assets in excess of $3 billion, the board also should determine whether members of the committee satisfy the additional requirements of this part. Because an insured branch of a foreign bank does not have a separate board of directors, the FDIC will not apply the audit committee requirements to such branch. However, any such branch is encouraged to make a reasonable good faith effort to see that similar duties are performed by persons whose experience is generally consistent with the Rule's requirements for an institution the size of the insured branch.

29. *"Independent of Management" Considerations.* In determining whether an outside director is independent of management, the board should consider all relevant information. This would include considering whether the director:

(a) Is or has been an officer or employee of the institution or its affiliates;

(b) Serves or served as a consultant, advisor, promoter, underwriter, legal counsel, or trustee of or to the institution or its affiliates;

(c) Is a relative of an officer or other employee of the institution or its affiliates;

(d) Holds or controls, or has held or controlled, a direct or indirect financial interest in the institution or its affiliates; and

(e) Has outstanding extensions of credit from the institution or its affiliates.

Appendix S

30. *Lack of Independence.* An outside director should not be considered independent of management if such director is, or has been within the preceding year, an officer or employee of the institution or any affiliate, or owns or controls, or has owned or controlled within the preceding year, assets representing 10 percent or more of any outstanding class of voting securities of the institution.

31. *Holding Company Audit Committees.* Members of an independent audit committee of a holding company may serve as the audit committee of any subsidiary institution if they are otherwise independent of management of the subsidiary. This would not, however, permit officers or employees of the holding company to serve on the audit committee of its subsidiary institutions. The audit committee of the holding company may perform all the duties of the audit committee of a subsidiary institution, even though such holding company directors are not directors of the institution.

32. *Duties.* The audit committee should perform all duties determined by the institution's board of directors. The duties should be appropriate to the size of the institution and the complexity of its operations, and include reviewing with management and the independent public accountant the basis for the reports issued under § 363.2(b). Appropriate additional duties could include:

(a) Reviewing with management and the independent public accountant the scope of services required by the audit, significant accounting policies, and audit conclusions regarding significant accounting estimates;

(b) Reviewing with management and the accountant their

assessments of the adequacy of internal controls, and the resolution of identified material weaknesses and reportable conditions in internal controls, including the prevention or detection of management override or compromise of the internal control system;

(c) Reviewing with management and the accountant the institution's compliance with laws and regulations;

(d) Discussing with management the selection and termination of the accountant and any significant disagreements between the accountant and management; and

(e) Overseeing the internal audit function.

It is recommended that audit committees maintain minutes and other relevant records of their meetings and decisions.

33. *Banking or Related Financial Management Expertise.* At least two members of the audit committee of a large institution shall have "banking or related financial management expertise" as required by section 36(g)(1)(C)(i). This determination is to be made by the board of directors of the insured depository institution. A person will be considered to have such required expertise if the person has significant executive, professional, educational, or regulatory experience in financial, auditing, accounting, or banking matters as determined by the board of directors. Significant experience as an officer or member of the board of directors or audit committee of a financial services company would satisfy these criteria.

34. *Large Customers.* Any individual or entity (including a controlling person of any such entity) which, in the determination of the board of directors, has such significant direct or indirect

credit or other relationships with the institution, the termination of which likely would materially and adversely affect the institution's financial condition or results of operations, should be considered a "large customer" for purposes of § 363.5(b).

35. *Access to Counsel.* The audit committee should be able to retain counsel at its discretion without prior permission of the institution's board of directors or its management. Section 36 does not preclude advice from the institution's internal counsel or regular outside counsel. It also does not require retaining or consulting counsel, but if the committee elects to do either, it also may elect to consider issues affecting the counsel's independence. Such issues would include whether to retain or consult only counsel not concurrently representing the institution or any affiliate, and whether to place limitations on any counsel representing the institution concerning matters in which such counsel previously participated personally and substantially as outside counsel to the committee.

36. *Forming and Restructuring Audit Committees.* Audit committees should be formed within four months of the effective date of this part. Some institutions may have to restructure existing audit committees to comply with this part. No regulatory action will be taken if institutions restructure their audit committees by the earlier of their next annual meeting of stockholders, or one year from the effective date of this part.

Other

37. *Modifications of Guidelines.* The FDIC Board of Directors has delegated to the Director of the FDIC's Division of Supervision authority to make and publish in The Federal Register minor technical amendments to the Guidelines in this

appendix (including the attached Agreed Upon Procedures in Schedule A to this appendix), in consultation with the other appropriate federal banking agencies, to reflect the practical experience gained from implementation of this part. It is not anticipated any such modification would be effective until affected institutions have been given reasonable advance notice of the modification. Any material modification or amendment will be subject to review and approval of the FDIC Board of Directors.

Schedule A to Appendix A—Agreed Upon Procedures for Determining Compliance With Designated Laws

This schedule A is attached to the Guidelines and Interpretations issued by the FDIC as appendix A to 12 CFR Part 363 adopted to implement section 36 of the FDI Act.

The Agreed Upon Procedures set forth in this schedule are referred to in guideline 19. They should be followed by the institution's independent public accountant (or, with respect to the procedures set forth in section I below, by the institution's internal auditor if the accountant is to perform the procedures set forth in section II) in order to permit the accountant to report on the extent of compliance with the Designated Laws (defined in guideline 12, and more specifically identified below) as required by section 36(e)(1) and (2).

Additional guidance concerning the role of the institution, its internal auditor, and its independent public accountant in assessing the institution's compliance with the Designated Laws is set forth in the Guidelines. All terms not otherwise defined in this schedule have the respective meanings ascribed to them in this part, the Guidelines in this appendix, and professional accounting and auditing literature.

Appendix S

Section I—Procedures for Individual Institutions

The following information should be obtained, and the indicated procedures should be performed, by the institution's independent public accountant in accordance with generally accepted standards for attestation engagements, or by the institution's internal auditor if the procedures set forth in section II of this schedule are to be performed by the accountant.

A. Loans to Insiders

1. *Designated Laws.* The following laws and regulations (Designated Insider Laws) should be read:

(a) The laws codified at 12 U.S.C. 375, 375a, 375b, 376, 1468(b), 1828(j)(2), 1828(j)(3)(B), 1817(k), and 1972; and

(b) The regulations set forth at 12 CFR 23.5, Part 31, 211.3(b)(4), Part 215, 337.3, 349.3, 563.43 and 935.2.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *General Information.* Obtain management's assessment of compliance with the Designated Insider Laws; all minutes (including minutes drafted, but not approved) of the meetings of the board and its committees; reports of examination, supervisory agreements, and enforcement actions issued by the institution's primary federal and state regulators, if applicable; all public documents filed under the Securities Exchange Act of

1934 with the FDIC, SEC, Federal Reserve Board, OCC, or OTS; and annual reports filed by insiders identifying their related interests as required by 12 CFR 215.7.

Procedure:

(i) Read the foregoing information.

(ii) Trace and agree each disclosed insider loan and other extension of credit to see that it is included on the list of Insider Transactions.

b. *Calculations.* Obtain management's calculation of the greater of 5 percent of the institution's year-end capital and unimpaired surplus or $25,000.

Procedure. Recalculate for mathematical accuracy, and trace amounts used in management's calculations to the institution's year-end Call Report or TFR.

c. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Insider Laws, including any written "Code of Ethics" or "Conflict of Interest" policy statements. If the institution has no written policies and procedures, obtain a narrative from management that describes the methods for complying with such laws, and includes provisions similar to those listed below.

Procedure: Ascertain that the policies and procedures include, or incorporate by reference, provisions consistent with the Designated Insider Laws for:

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(i) Defining terms;

(ii) Prohibiting and restricting loans to insiders *(i.e.* directors, executive officers and principal shareholders and their related interests);

(iii) Maintaining records of loans to insiders;

(iv) Requiring reports and disclosures by the institution and by executive officers, directors, and principal shareholders;

(v) Disseminating policy information;

(vi) Revising policies to reflect subsequent changes in the law;

(vii) Educating employees about the legal requirements and management's related policies and procedures;

(viii) Prior approval of the board of directors or its committees, as appropriate; and

(ix) Reporting insider loans to regulatory agencies on the institution's Call Report or TFR.

d. *Insider Transactions.* Obtain a list of loans or other extensions of credit to insiders (including their related interests) during the fiscal year and management's written representations regarding:

(i) The completeness of the list, and

(ii) Whether the terms of insider transactions are comparable to those that would have been available to unaffiliated third parties.

Procedure: Select a sample of the insider transactions from the list. For each transaction in the sample selected:

(1) Ascertain that each executive officer and principal shareholder (or related interest) has reported annually to the board of directors, on or before January 31 of the following year, and indebtedness to correspondent banks, and that such report states:

(a) The maximum amount of indebtedness during the previous calendar year;

(b) The amount of indebtedness outstanding 10 days prior to report filing; and

(c) A description of the loan terms and conditions, including the rate or range of interest rates, original amount and date, maturity date, payment terms, security, and any unusual terms or conditions.

(2)(a) Trace and agree amounts outstanding by insiders to the schedule aggregating indebtedness of all insiders on the institution's year-end Call Report or TFR;

(b) Obtain from management documentation that indicates whether the specific extensions of credit, at the option of the institution, will become due and payable at any time that the insider is indebted to any other insured institution in an aggregate amount greater than the amount specified for a category of credit in 12 CFR 215.5(c);

(c) Obtain from management a copy of the institution's written notification to the insider to ascertain whether the insider has been informed of the reporting requirements relative to insider transactions and has acknowledged such requirements;

(d) If the credit exceeds the lesser of the calculation obtained in paragraph 2(b), or $500,000, read the minutes of the meetings of the board of directors and determine whether the minutes indicate that the credit was approved in advance by the board and the insider abstained from participating directly or indirectly in voting on the transactions; and

(e) Obtain management's calculated legal lending limit for the credit and ascertain whether the amount of the credit exceeds such limit.

(3) For executive officers, directors, and principal shareholders of the institution included in the sample, obtain a written history of the insider's overdrafts for the year and obtain management's representation whether that history is complete. In addition,

(a) Inquire whether cash items for the individual are being held by the institution to prevent an overdraft, and

(b) Trace and agree subsequent payment by the insider of the insider's overdrafts to records of the account at the institution.

(4) For overdrafts of executive officers and directors included in the sample that are being paid by the institution for the executive officer and director on an account at the institution:

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(a) Trace and agree to a written, pre-authorized, interest-bearing extension of credit plan that specifies a method of repayment; or

(b) Trace and agree to a written, pre-authorized transfer of funds from another account of the insider at the institution, or

(c) For aggregate amounts of $1,000 or less, obtain a written representation from management that

(i) It believes the overdraft was inadvertent,

(ii) The account was overdrawn in each case for less than 5 business days, and

(iii) The institution charged the executive officer and director the same fee that it would charge any other customer in similar circumstances.

(5) For extensions of credit to an executive officer selected, ascertain that each credit was:

(a) Preceded by submission of financial statements;

(b) Promptly reported to the board of directors; and

(c) Made subject to the condition, as specified in the note or other evidence of indebtedness, that the extension of credit will become, at the option of the institution, due and payable at any time that the executive officer is indebted to other

insured institutions in an aggregate amount greater than the executive officer would be able to borrow from the institution.

(6) Based on the types of transactions in the sample selected, select a sample of similar transactions with persons who are not insiders of the institution or its affiliates as of the same dates or within two weeks of the insider transaction. Compare the terms of the transactions with the persons not affiliated with the institution to those with insiders, and note in the findings any material differences in the terms favorable to insiders compared to the terms of the transactions with persons not affiliated with the institutions or its affiliates.

(7) Aggregate the indebtedness to executive officers, directors, and principal shareholders of the institution and to their related interests from the list obtained as of the end of the fiscal year and one other day selected during the year. Compare this total with 100 percent of the institution's unimpaired capital and surplus at the one day selected during the year and the end of its fiscal year. (The unimpaired capital and surplus calculated from the most recent Call Report or TFR may be used, unless there is reason to believe that a significant change has taken place between the dates.) Report any excess as an exception in the findings.

e. *Executive Officers' Reports.* Obtain a list of all written reports made by executive officers of the institution concerning debt with other insured institutions, and management's representation concerning the completeness of such list.

Procedure. Select a sample of written reports. For reports selected, note any reported aggregate extensions of

credit in excess of the amounts management represents that the executive officer would have been able to borrow from the reporting institution and whether the report was made within 10 days of the date the indebtedness reached such a level. Obtain management's calculation of

(i) The aggregate amount of loans and other extensions or lines of credit to the executive officer, and

(ii) 2.5 percent of the institution's capital and unimpaired surplus.

Recalculate management's computations for mathematical accuracy and trace amounts used in management's computations to the institution's Call Report or TFR. Ascertain whether the aggregate amount of the credits for the executive officer exceeds the greater of 2.5 percent of the institution's capital and unimpaired surplus or $25,000, but in no event more than $100,000, unless such credits are used to finance the education of the executive officer's children or the officer's principal residence. If the credit extended is a real estate loan, obtain documentation for the credit and note whether such documentation contains representations that:

(i) The purpose of the credit is for the purchase, construction, maintenance, or improvement of the executive officer's principal residence;

(ii) The credit is secured by a first lien on the residence; and

(iii) The executive officer owns or expects to own the residence after the extension of credit.

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B. Dividend Restrictions

1. *Designated Laws.* The following federal laws and regulations (Designated Dividend Laws) should be read:

a The laws codified at 12 U.S.C. 56, 60 1467(a)(f), 18310; and

b The regulations set forth at 12 CFR 5.61, 5.62, 6.6, 7.6120, 208.19, and 563.134.

2. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

a. *Management 's Assessment.* Obtain management's assessment of the institution's compliance with the Designated Dividend Laws and any applicable state laws and regulations cited in management's assessment. Also obtain management's written representation whether dividends declared comply with the legal limitations and any restrictions on dividend payments under any supervisory agreements, orders, or resolution of any regulatory agency (including a description of the nature of any such agreement, order, or resolution).

b. *Policies and Procedures.* Obtain the institution's written policies and procedures concerning its compliance with the Designated Dividend Laws. If the institution has no written policies and procedures, obtain from the institution a narrative that describes the institution's methods for complying with Designated Dividend Laws, and includes provisions similar to those below.

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Procedure: Ascertain whether the policies and procedures include, or incorporate by reference, provisions which are consistent with the Designated Dividend Laws. For banks and savings institutions, these would include capital limitation tests, including section 38 of the FDI Act, earnings limitation tests, transfers from surplus to undivided profits, and restrictions imposed under any supervisory agreements, resolutions, or orders of any federal or state bank regulatory agency. For savings associations, include prior notification to the OTS.

c. *Board Minutes.* Obtain the minutes of the meetings of the board of directors for the most recent fiscal year to ascertain whether dividends (either paid or unpaid) have been declared.

Procedure: Trace and agree total dividend amounts to the general ledger records and the institution's appropriate Call Reports or TFRs filed with regulators.

d. *Calculation.* Obtain management's computation of the amount at which declaration of a dividend would cause the institution to be undercapitalized.

Procedure: Recalculate management's computation (for mathematical accuracy) and compare management's calculations to the amount of any dividend declared to determine whether it exceeded the amount.

e. *National and State Member Banks.* Obtain management's computation concerning its compliance with 12 U.S.C. 56, "Capital Limitation Test," 12 U.S.C. 60, "The Earnings Limitation Test," and transfers from surplus to

undivided profits after payment of the dividends referenced in paragraph 2c, above.

Procedure: Recalculate management's computations (for mathematical accuracy) and compare management's calculations to the standards defined in the test set forth in paragraph 2d, above, to ascertain whether the dividends declared fall under the permissible level under this standard. If dividends are not permissible under such standard, ascertain if the dividends were declared under approval of the appropriate federal banking agency or any other exception. If not, report the exception in the findings.

f. *Savings Associations.* Obtain management's documentation of the OTS determination whether the institution is a Tier 1, Tier 2, or Tier 3 savings institution and management's computation of its capital ratio after declaration of dividends under the Tier determined by the OTS. For dividends declared, obtain a copy of the savings institution's notification to the OTS to ascertain whether notification was made at least 30 days before payment of any dividends.

Procedure: Recalculate management's computations (for mathematical accuracy) and trace amounts used by management in its calculations to the institution's TFRs.

Section II—Procedures for Independent Public Accountant

If the internal auditor has performed the procedures set forth in section I, the following procedures may be performed by the independent public accountant if neither the FDIC nor the appropriate federal banking agency has objected in writing. If the procedures in section I have been performed by an internal

auditor employed by a holding company, such procedures should be applied to each subsidiary institution (a Covered Subsidiary) subject to this part. The report of procedures performed and list of exceptions found by the internal auditor, identifying the institution with respect to which any exception was found, should be submitted to the audit committee of the board of directors.

A. *Review of Designated Laws.* The Designated Insider Laws and Designated Dividend Laws applicable to the institution should be read.

B. *Information and Procedures.* Obtain from management of the institution, and read, the following information for the institution's most recent fiscal year through the date of the attestation report, and perform the procedures indicated with respect to such information:

1. *Designated Laws.* Read Section I of this schedule. Obtain management's assessment contained in its management report on the institution's or holding company's compliance with the Designated Laws.

2. *Internal Auditor's Workpapers.* If an internal auditor performed the procedures in section 1, obtain the internal auditor's workpapers documenting the performance of those procedures on the institution, including all Covered Subsidiaries, and the chief internal auditor's written representation that:

(a) The internal auditor or audit staff, if applicable, performed the procedures listed in section I on the institution and each Covered Subsidiary;

(b) The internal auditor tested a sufficient number of

transactions governed by the Designated Laws so that the testing was representative of the Institution's or Covered Subsidiary's volume of transactions;

(c) The workpapers accurately reflect the work performed by the internal auditor and, if applicable, the internal audit staff;

(d) The workpapers obtained are complete; and

(e) The internal auditor's report, which describes the procedures performed for the preceding fiscal year as well as the Internal auditor's findings and exceptions noted, has been presented to the institution's audit committee.

Procedure: Compare the work papers to the procedures that are required to be performed under section 1, and report as an exception any procedures not documented and any procedures for which the sample size is not sufficient. Compare the exceptions and errors listed by the internal auditor in its report to the audit committee to those found in the workpapers, and report as an exception any exception or error found in the internal auditor's workpapers and not listed in the internal auditor's list of exceptions.

C. *Testing by Independent Public Accountant.* The accountant should perform the procedures listed in section I on a representative sample of the transactions of the institution and Covered Subsidiaries to which each of the Designated Laws applies. The sample tested at each institution, or Covered Subsidiary, should be at least 20 percent of the size of the sample tested by the internal auditor at such institution, although samples selected should be from the population at large. If the testing is

being performed on a holding company with more than one Covered Subsidiary, the sample tested for each Designated Law should include transactions from each such subsidiary at least every other fiscal year. If the holding company has more than eight Covered Subsidiaries, the sample of transactions tested for each Designated Law should include transactions from each such subsidiary at least every third fiscal year.

D. *Reports Concerning Holding Companies.* Only one report of any exceptions noted from application of the procedures in section II performed by the independent public accountant on all Covered Subsidiaries of a holding company should be filed as required by guideline 4, but the report should identify for each exception or error noted, the identity of the Covered Subsidiary to which it relates.

[Codified to 12 C.F.R. Part 363, Appendix]

NOTE

Preamble to Part 363

III. Background

In September 1992, the FDIC proposed regulations (57 FR 42516, Sept. 15, 1992) to implement the provisions of section 112 of FDICIA, entitled "Independent Annual Audits of Insured Depository Institutions." The requirements of section 112 apply to fiscal years of insured depository institutions that begin after December 31, 1992.

The new statutory provision, contained in section 36, requires the FDIC, in consultation with the appropriate federal

banking agencies, to promulgate regulations requiring institutions over a certain asset size to have an annual independent audit of their financial statements in accordance with generally accepted auditing standards and section 37 of the FDI Act, and the institution's independent public accountant to notify the FDIC upon termination of services. Section 36 also requires the federal banking agencies jointly to issue rules of practice governing enforcement actions against independent public accountants.

IV. Discussion of Final Rule and Public Comments

Section 36 requires the FDIC, in consultation with the other appropriate federal banking agencies, to prescribe regulations concerning only a few specified provisions of the statute. It also permits, but does not require, the FDIC to undertake rulemaking pursuant to its general rulemaking authority concerning other provisions of the statute.

The FDIC has elected to limit, with few exceptions, its rulemaking to a final rule to implement those provisions of section 36 which specifically require rulemaking. It is persuaded that that approach is consistent with the letter and spirit of the law and with comments received, with which the FDIC concurs, that the final rule not impose unnecessary regulatory burdens, provide appropriate flexibility, and be reasonably cost-effective.

Accordingly, the final rule implements the "Annual Independent Audits of Financial Statements" requirement of section 36(d)(1) of the FDI Act and the "Notice by Accountant of Termination of Services" requirement of section 36(g)(5). The FDIC anticipates that, jointly with the other appropriate federal banking agencies, it promptly will issue rules of practice with

respect to removal, suspension or bar of an independent public accountant from performing audit services for insured depository institutions as required by section 36(g)(4).

The final rule also restates, by way of emphasis, selective provisions of the statute. That is not intended, however, to imply that the FDIC does not expect affected insured depository institutions to comply with all provisions of the statute. Instead, it makes clear that the final rule does not expand the scope or interpretation of the statutory requirements.

The FDIC received over 305 comment letters concerning the proposed rule. The largest group of comments, approximately 120, was from banks, about eight percent of which were institutions that were exempt from proposed Part 363. Another 23 percent were from bank holding companies, including most of the 25 largest in the United States. Twenty-two letters were from thrifts, four of which are among the ten largest in the country.

The FDIC has reviewed the proposal in light of these comments. The majority of the commenters criticized the proposed requirements, and the cost to comply with the proposed rule. The comments are discussed below.

A. Scope.

Section 36 left to the FDIC's discretion whether to exempt institutions having total assets in excess of $150 million. The FDIC has exercised its discretion to mitigate the financial burden of compliance by raising the threshold from $150 million to $500 million, thereby exempting from the final rule approximately two-thirds of institutions that would have been subject to section 36, but which pose less of a risk to the deposit insurance funds,

while bringing approximately 75 percent of the banking assets in the U.S. within the scope of the regulation.

More than 96 percent of institutions with $500 million or more in total assets report they already engage an independent public accountant to perform an annual audit of their financial statements or that their parent company engages an independent public accountant to do the same for its consolidated statements. All of the remaining institutions in this asset range engage an independent public accountant to provide some audit services. Many of these institutions or their holding companies also have audit committees that comply with the final rule. These facts suggest the final rule will not impose unacceptable burdens on affected institutions.

Compliance by Subsidiaries of Holding Companies

The requirements for an independent audit may be satisfied for subsidiaries of holding companies by an independent audit of the holding company. The other requirements of section 36 may be satisfied for subsidiaries if "services and functions" comparable to those required by the statute are provided at the holding company level, and, either the institution has total assets, as of the beginning of each fiscal year, of less than $5 billion; or, total assets between $5 billion and $9 billion, and it received a CAMEL (or comparable) rating of one or two at its most recent examination.

If a subsidiary meets the foregoing criteria, an independent public accountant may examine and attest to the subsidiary's assertions on the consolidated entity's internal control system, and would not be required to examine and attest to the systems of each subsidiary.

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B. Reporting Requirements

1. Definitions

Definitions in the proposed rule have been eliminated in the final rule. Certain relevant terms are already defined in the FDI Act and professional accounting and auditing literature.

2. Annual Report

The final rule requires each covered institution to prepare an annual report containing financial statements prepared in accordance with generally accepted accounting principles (GAAP) that have been audited by an independent public accountant, and to file such report within 90 days after the end of each fiscal year. The FDIC has adopted commenters' suggestions that the language of the final rule more closely track the statute.

The proposal that institutions may use Call Report items or an audit of the Call Report schedules has been deleted as being unnecessarily confusing, and because such schedules do not comply with GAAP. In addition, a proposed provision on consolidation has been eliminated.

Many commenters requested that the FDIC delete the proposed provision requiring an audited reconciliation of an institution's capital reported under GAAP with the capital calculated under regulatory capital standards. Because this reconciliation is not specifically required by the statute, the FDIC eliminated it from the final rule.

3. Management Report

Internal controls for financial reporting. Section 36

requires that each institution prepare an annual report containing a statement of management's responsibility for establishing and maintaining an adequate internal control structure and an assessment of the effectiveness of internal controls for financial reporting.

To comply with the reporting and attestation requirements of the final rule, both management and the independent public accountant should refer to terms, including "internal control structure" and "control procedures," in professional accounting and auditing literature.

The FDIC sought comment on whether it should leave the development of internal control criteria to institutions. After careful consideration, the FDIC has decided that each institution should determine its own standard for an internal control structure and procedures for financial reporting, but that any assessment by management should include sufficient information to enable the independent public accountant separately to examine and report on management's assessment.

In response to a number of suggestions, the FDIC has removed the proposed requirement that "material matters" be assessed. Nevertheless, an assessment must include all significant items.

Compliance with laws and regulations. Section 36 requires management to assess its own compliance with designated laws and regulations, and to evaluate the effectiveness of the operation of its internal control structure and procedures for compliance with such laws and regulations.

The final rule also requires that a covered institution engage

an independent public accountant to report on procedures for compliance with designated laws and regulations. In response to requests from many commenters the proposed requirement that management provide a description of its handling of material weaknesses and inadequacies and other reportable conditions was deleted. Commenters correctly pointed out that these matters should be resolved by the independent public accountant and management working together to determine the appropriate action to correct any deficiency. The proposal that institutions submit the names and occupations of audit committee members also was deleted because this information is available to examiners.

Many commenters addressed the proposal that an independent public accountant provide negative assurance that an institution has complied with FDIC assessment requirements. They noted section 36 does not require this, and that to require FDIC assessment auditors and independent public accountants to review the assessment calculations is duplicative and would result in unjustifiable additional expense. Accordingly, the FDIC has eliminated the requirement in the final regulation.

Many commenters requested that the accountant's management letter be eliminated from the filing requirement. However, section 36 specifically requires that the management letter, audit report, and any other report provided by the independent public accountant during the year be filed within 15 days of its receipt.

In the final rule, the proposed requirement that institutions retain workpapers documenting management's review of its statements in the management report has been eliminated because it is not required by section 36, and is not essential to the rule.

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Notice of engagement or change of accountants. The final rule establishes notice requirements for institutions whenever there is a change of accountant. Several commenters questioned whether institutions had to notify the FDIC and appropriate federal banking agency immediately after the final rule is effective. Those institutions that have already notified the FDIC and the appropriate federal banking agency of their accountant's identity need make no additional notification until there is a change in accountant.

C. Independent Public Accountant Reporting and Notice Requirements

1. Internal Control Attestation

The final rule requires institutions to engage an independent public accountant to perform an examination level attestation and report separately on the assertions contained in management's report regarding management's assessment of the effectiveness of the institution's internal control structure and procedures for financial reporting. The attestation should be as of the date of management's assertions and should be in accordance with generally accepted standards for attestation engagements.

2. Compliance With Laws and Regulations Attestation

The final rule requires that each institution engage an independent public accountant to test the institution's compliance with designated laws and regulations through the performance of agreed upon procedures. The Guidelines set forth such procedures.

3. Other Duties of Independent Public Accountants

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The proposal required the independent public accountant to inform the appropriate federal banking agency of any apparent criminal violation if management had not already done so. A number of commenters objected to this requirement because it is not specifically mandated by section 36, and it does not allow time for the institution to investigate the alleged violation before it must be reported to regulators. The comments are valid and the provision has been deleted.

4. Notice by Accountant of Termination of Services

The FDIC could not adopt the suggestion of some commenters that the accountant notice provisions be deleted. Section 36 requires such notice. However, the final rule extends from five days to 15 days the period of time within which an independent public accountant must file a termination of services report.

D. *Audit Committees*

Section 36 requires that each institution have an independent audit committee entirely made up of outside directors who are independent of the institution. For large institutions, as defined in the final rule, there are additional criteria: The large institution's audit committee must include members with banking or related management experience, have access to its own outside counsel, and not include any large customers of the institution.

The final rule reiterates the requirements of the statute, but does not include specific definitions of "independent person," "large customer," and "banking and financial management expertise". The FDIC expects boards of directors to determine if an outside director meets audit committee requirements. Such a determination will be subject to review by examiners.

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The FDIC requested comment on its proposed definition of "large institution". A large majority of commenters recommended that the proposed large institution asset threshold be increased. After careful consideration, the FDIC has adopted an asset threshold of $3 billion. With this threshold, fewer than 2 percent of the nation's institutions will be defined as "large", yet more than half of the assets insured by the Bank Insurance Fund and the Savings Association Insurance Fund will receive the additional protection afforded by the presence of independent directors who have banking or financial management expertise, and are not large customers of the institution.

E. Insured Branches of Foreign Banks

A few commenters noted that the proposal did not separately address the responsibilities of insured branches of foreign banks. Application of section 36 statutory requirements to such branches is complicated because, unlike other institutions, they are not separately incorporated or capitalized. The Guidelines facilitate compliance by such branches.

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